The CANADA ROUND

David M. Brown,
Fred Lazar,
and Daniel Schwanen

FREE TO MOVE

Strengthening the Canadian Economic Union

A Series
on the Economics
of Constitutional
Renewal

C.D. Howe Institute

92-05021/

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Free to Move:

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The Canada Round:
A Series on the Economics of Constitutional Renewal — No. 14

John McCallum, Series Editor

C.D. Howe Institute

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Hull, Quebec J8X 3X2

This book is printed on recycled, acid-free paper.

Canadian Cataloguing in Publication Data

Brown, David M. (David Manley), 1958–
Free to move

(The Canada round ; ISSN 1183-6253 ; no. 14)
Includes bibliographical references.
ISBN 0-88806-300-8

1. Interprovincial commerce – Canada. 2.* Interprovincial relations – Canada.* 3. Manpower policy – Canada. 4. Canada – Economic policy – 1991– .* I. Lazar, Fred, 1946– . II. Schwanen, Daniel. III. C.D. Howe Institute. IV. Title. V. Series.

HC113.B76 1992 330.971 C92-094257-1

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Quotation with appropriate credit is permissible.
Printed and bound in Canada by Hignell Printing Limited,
Winnipeg, Manitoba, May 1992.

Contents

Foreword v

The Study in Brief vii

Open Exchange:
Freeing the Trade of Goods and Services within the Canadian Economic Union,
by *Daniel Schwanen* 1

Efficiency, Capital Mobility, and the Economic Union,
by *David M. Brown* 38

Labor Market Policies and the Jurisdictional Distribution of Powers,
by *Fred Lazar* 99

The Contributors 147

Members of the C.D. Howe Institute 149

Foreword

Canada appears poised to embark on an historic political reconfiguration. It is essential that this process be undertaken with a clear and widely diffused understanding of the well-spring of Canadians' economic prosperity.

It is with that in mind that the C.D. Howe Institute presents this series of monographs entitled *The Canada Round*. The series assembles the work of many of Canada's leading economic and political analysts. The monographs are organized into two groups. The first group, called "The Economics of Constitutional Renewal," rests on the assumption of renewed federalism and is organized around economic themes. It examines the economic goals that Canadians have set for themselves, as well as the means of achieving them and the influence of alternative constitutional structures.

The second group of studies, called "The Economics of the Breakup of Confederation," examines the economic consequences of Quebec independence for both Quebec and the rest of Canada. A unique feature of the "Breakup" studies is that they are integrated with the research that has already been carried out by Quebec's Bélanger-Campeau Commission. Where appropriate, each of the studies in this group includes a summary of the relevant analysis by the Bélanger-Campeau Commission, contributions by experts from across Canada, as well as shorter critiques or replies. This format, we believe, will help to pierce Canada's "several solitudes" and create a pan-Canadian meeting of minds.

The Canada Round is not intended to alarm or frighten — the process of collective political definition in this country will turn on more than simply questions of dollars and cents. And, as these monographs will reveal, economics rarely produces an open-and-shut case as to the superiority of one possible set of rules over another. Even if it could do this, it would be unwise to assume that

economic analysis alone could change the minds of those who are already committed to a particular vision of the political future.

It is equally clear, however, that Canadians are now seeking a greater understanding of the links between the economy, the Constitution, and legal and political life. A significant reform of the Constitution will influence the economy, in some cases for the better; a rending of the Constitution under conditions of acrimony will almost certainly damage it. Thus, the purpose of the series is to help Canadians think constructively about the benefits and costs of alternative constitutional designs.

Underlying the series is a focus on the economic well-being of Canadians, now and in the future. To best insure this well-being over the short run, Canada needs calm, open negotiations in which efforts are made to understand and incorporate the aspirations of all the participants. This series of monographs is dedicated to that effort.

John McCallum, the series editor and Chairman of the Department of Economics at McGill University, organized the intellectual input. Within the C.D. Howe Institute, David Brown, Senior Policy Analyst, played a coordinating role. This fourteenth monograph in the series was copy edited by Lenore d'Anjou and Barry A. Norris, and desktop published by Brenda Palmer. As with all C.D. Howe Institute publications, the analysis and views presented here are the responsibility of the authors and do not necessarily reflect the opinions of the Institute's members or Board of Directors.

Thomas E. Kierans
President and
Chief Executive Officer

The Study in Brief

This volume in "The Canada Round" focuses on resource mobility within the Canadian economic union. Daniel Schwanen deals mainly with the mobility of goods and services, while David Brown is concerned with capital mobility. Fred Lazar examines labor market policies more generally, looking not only at interprovincial mobility, but also at the appropriate division of powers in this area.

Schwanen begins by distinguishing among three kinds of barriers to trade:

- type I barriers involve outright discrimination — for example, government procurement policies that favor local firms;
- type II barriers involve regulatory measures that indirectly impede mobility — for example, packaging rules that vary across provinces;
- type III barriers involve policies that attract resources to one province at the expense of other provinces — for example, provincial subsidies to new investment.

The removal of type I barriers typically involves measures to forbid discrimination, while the reduction of the other two types of barriers requires measures to harmonize or coordinate economic policies.

The cost of these barriers is usually estimated to be between 0.5 percent and 1.0 percent of gross domestic product. If, however, one considers dynamic effects as well as business fears that such barriers might increase in the future, then the benefits from removing interprovincial barriers in a permanent and credible fashion are likely to be substantially larger than these numbers would suggest.

Schwanen goes on to provide a detailed survey of earlier proposals to free the Canadian internal market, as well as an analysis of Canadian actions to date and measures taken in the European Community and elsewhere. Based on this evidence, he argues that while future progress must involve direct intergovernmental cooperation

— as opposed to "edicts" from Ottawa — past efforts along these lines have not been very successful. New approaches are needed.

Schwanen's major policy recommendations are as follows. Subject to limited and well-defined exceptions, all governments should be barred from erecting type I discriminatory barriers by a strengthened section 121 of the Constitution. Next, type II barriers should be addressed in two steps. First, a package of objectives should be adopted *unanimously* by the federal government and the provinces. Second, individual measures flowing from this package would be developed by teams of experts and adopted by a qualified majority of the governments. There would be no opting out. Finally, while some subsidies, or type III barriers, may be justified, governments should develop a code of conduct on this subject.

David Brown argues that capital in Canada today is highly mobile and that such barriers as exist do not create enough harm to warrant legal scrutiny. He presents evidence to suggest that capital is more mobile across the provinces than it is across the national borders of industrialized countries. This evidence is based on the finding that savings-investment imbalances tend to be much greater for the ten provinces than they are for 22 industrial countries. It appears, then, that Canada's national banking system and common currency have done a good job in facilitating the flow of capital from regions where saving exceeds investment opportunities to regions characterized by investment opportunities in excess of local saving.

Moreover, Brown notes, Canada has kept pace with the state of the art in financial services, with the result that the small investor can "'play the yield curve,' take a position on the Canadian dollar, and manage proportionate investments in cash, fixed income, and equity, all within a tax-deductible registered retirement saving plan."

Brown then considers three Canadian institutions that might conceivably distort capital flows in Canada: the Quebec Stock Savings Plan, the Caisse de dépôt et placement du Québec, and the Alberta Heritage Savings Trust Fund, although he argues that these institutions do not pose serious problems in terms of the free movement of capital. He acknowledges that type III barriers to capital

mobility are a potential problem on the horizon if the Canadian federation were to become more decentralized, and/or if type I and type II barriers were to be eliminated. Brown suggests, however, that type III barriers should not be addressed until they actually do become a problem.

A subtheme running through Brown's essay is that the traditional notion of economic "efficiency" is based on static concepts that ignore dynamic processes involving local entrepreneurship, concentrated clusters of economic activity, and increasing returns to scale. As a result, he argues, the ill-defined notion of "efficiency" should not be used in the Canadian Constitution.

Fred Lazar examines four branches of labor market policy: training, apprenticeship, occupational licensing, and workers' compensation and occupational safety and health. In each case, following a review of the literature, he asks whether there is a rationale for government intervention and, if so, by which level of government.

On training, Lazar argues that some federal presence is justified because of "spillovers" — whereby job opportunities may exist in other provinces — and "externalities" — whereby part of the gains from training may accrue to other provinces. While these points suggest a funding and information role for the federal government, program design and delivery could be left to the provinces. Lazar also acknowledges that there are economic grounds for delegating greater powers in this area to Quebec than to other provinces. He is critical of current efforts in both apprenticeship and occupational licensing, arguing that provincial programs in these areas tend to reduce mobility and rigidify skills and occupational requirements. Moreover, he says, such programs often become anticompetitive devices to limit entry. He argues for either mutual recognition of provincial standards or the development of national standards, in combination with a more aggressive use of the *Competition Act*. Finally, Lazar says workers' compensation and occupational health should remain matters of exclusive provincial jurisdiction.

John McCallum
Series Editor

Open Exchange: *Freeing the Trade of Goods and Services within the Canadian Economic Union*

Daniel Schwanen

The debate over the kind of economic union that will benefit all Canadians is as old as Canada itself. From its inception, the country has had a significant economic purpose. The original intent of Confederation was not only to resolve domestic political rivalries and form a common defense against feared U.S. expansionism but also, in the words of the preamble to the *Constitution Act*, 1867, to "conduce to the welfare of the Provinces." The framework sought has been one in which the country as a whole, the communities within it, and individual citizens could create wealth and enjoy the fruits of their productive activity. This 125-year-old debate has recently taken on new dimensions with the phenomenon of worldwide economic integration — the consequences of which reach within the structure of individual trading nations — and with the renewed emphasis on the links among standard of living, economic productivity, and trade.

One of the most interesting aspects of today's discussion is that few Canadians, whether they favor political decentralization or centralization, will say that they are against the idea of a stronger

I wish to thank John McCallum at McGill University, Ken Norrie at the University of Alberta, and Tim Whitehead at the CIBC for their many useful comments on earlier versions of this paper.

economic union.[1] The elementary principle of such a union — removing barriers to the interprovincial mobility of goods, services, capital, and people — may seem even less controversial, a potentially uniting issue in the current political and economic debate.

Yet when the discussion turns to the means of ensuring such mobility, the question of whether one or the other level of government (or all of them) or the courts should be given the power to strike down trade barriers quickly becomes controversial. A general stumbling block is the view that democratically elected governments have a right to adopt any economic measure within their powers — even if it does not help their constituents' lot in the final analysis and even if it is detrimental to citizens in other jurisdictions. Another type of objection is rooted in a mistrust of the capacity of existing institutions to effect the necessary changes in a fair and expeditious way. Thus, observers who disagree with current federal policies do not feel inclined to give more economic power to Ottawa. Groups that feel left out of central policy-setting claim that Ottawa's power needs to be balanced by strengthened representation of certain provinces or stakeholders in the current decisionmaking process. Most observers are openly skeptical of the provincial governments' political will to remove trade barriers among themselves. Yet the idea of asking the courts to decide between acceptable and unacceptable barriers is also very controversial, since such decisions cannot always be based on well-defined criteria.

Too often these debates confuse nation-building with an attempt to entrench particular and often contradictory political agendas in the national fabric. What we really need are institutions that will operate with a sense of economic realism, promote consensus, and allow for flexibility. It is an observable fact that economic dynamism is a precondition for far-reaching social policies. It is also

1 Even the Quebec Liberal Party's Allaire Report, which advocates massive decentralization of federal powers to Quebec, explicitly advocates a stronger Canadian economic union in no fewer than 12 passages. See Quebec Liberal Party, Constitutional Committee, *A Quebec Free to Choose*, chaired by Jean Allaire (Quebec, January 28, 1991).

probably true that, in a country such as Canada, economic dynamism can only be the product of such institutions. In other words, social equity and economic efficiency need not be antithetical. Without both goals, worthwhile objectives will not be attained, or their purpose will be defeated by a process that pits one group against another.

In this context, this essay addresses why and how we should strengthen the Canadian internal market. The next section of the paper reviews the economic dimensions of the problem in Canada. The third section examines recommendations on interprovincial trade barriers contained in previous reports, and the fourth looks at what has been accomplished so far. Next comes a section on internal trade liberalizations elsewhere, particularly in the European Community and Australia. In the sixth section, I draw on the previous material to derive a set of operational principles for enhancing the mobility of goods and services within the Canadian internal market. The final section presents specific recommendations.

The Economic Issues

An enduring proposition in economics is that, under a fairly general set of conditions, one jurisdiction's removal of trade barriers usually benefits not only its trading partners but also itself.[2] It follows that a general lowering of barriers brings benefits to all jurisdictions within a certain economic space — though not to every firm or individual therein.

It is generally understood that these gains come from three sources:

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2 In the words of well-known economist Paul Krugman, who is no traditional free-market theorist, and co-author Maurice Obstfeld, this idea is "probably the most important insight in all of international economics." Paul Krugman and Maurice Obstfeld, *International Economics: Theory and Policy* (Glenview, Ill.: Scott, Foresman and Company, 1988), p. 4.

- *Greater efficiency through better use of available resources.* When purchasers have an increased choice of sources for a product or service and can select the least costly one, they can maximize their income. Whatever way they use this additional income — for goods and services, for savings directed toward investment, or for taxes that are used to provide additional public services — the economy as a whole ends up producing more for the same price, so the overall standard of living increases.
- *Economies of scale.* Freer interregional trade can lead to the development of industries around "clusters"[3] within certain areas, which lowers the costs for all firms within the industry and for their customers. Economies of scale are also realized when the opening of a market allows producers to lower their average costs simply by increasing output. Consumers benefit from these lower costs — provided the competition from substitutes or imports is sufficient to prevent one firm from dominating the market for a particular good or service.
- *The dynamic impact of an open trading environment.* With increased competitive pressure, firms must innovate in order to remain competitive. This environment fosters the emergence of firms that can constantly improve their way of doing things and adapt quickly to new technologies. Such firms deliver the best value to customers, in contrast to the typical behavior of firms that are protected from competition.

Despite general acceptance of the theory and despite solid evidence linking economic growth and openness to trade,[4] unilateral dismantling of trade barriers is rare. The reasons are often political. For instance, unilateral removal of trade barriers might weaken a bargaining position in trade negotiations. More often, domestic interests

3 In Porter's analysis, a cluster consists of factors of production, knowhow, customers, and supporting industries. See Michael E. Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990).

4 The evidence is surveyed in World Bank, *World Development Report 1991: The Challenge of Development* (New York: Oxford University Press for the World Bank, 1991), pp. 96–101.

that benefit from trade barriers — at the expense of the general public or of other jurisdictions — can muster the political clout to extend existing protection.

Economic arguments also justify the existence of barriers under certain conditions. For instance, if barriers imposed by government lead to a suboptimal use of resources in one area, it may be possible for the latter's authorities to restore part of their jurisdiction's original competitive position by imposing certain restrictions to trade.[5] For example, local barriers to trade in a federation may be aimed at reversing the deleterious effects of national policies, such as the impact on nonmanufacturing areas of national tariffs on manufactured imports.[6]

Barriers to Trade in Canada

Observers speak frequently of the trade barriers within Canada, and many have attempted to tally them.[7] For ease of exposition here, it is useful to identify three types of undesirable interprovincial barriers to trade in goods and services and to give some relevant examples. That these barriers are undesirable is a key concept supporting the finding that they should be removed, since not everything that impedes mobility is a realistic or desirable target for

5 Of course, a situation in which neither government imposed a barrier would still be preferable.

6 The idea being that, although a new distortion will come at a cost to consumers and taxpayers, it will also correct some of the inefficient employment of resources created by the initial barrier, thus resulting in higher incomes. Economists caution that much must be known about the precise impact of both the original distortion and any new one to be imposed before we can be sure that such new measures will not, in fact, reduce welfare. See Robin Boadway, *The Constitutional Division of Powers: An Economic Perspective* (Ottawa: Economic Council of Canada, 1992).

7 See, for example, Michael J. Trebilcock et al., "Provincially Induced Barriers to Trade in Canada: A Survey," in Michael J. Trebilcock, et al., eds., *Federalism and the Canadian Economic Union* (Toronto: Ontario Economic Council, 1983); Canada West Foundation, *The Canadian Common Market: Interprovincial Trade and International Competitiveness* (Calgary, 1985); and Canadian Manufacturers' Association, *"Canada 1993": A Plan for the Creation of a Single Economic Market in Canada* (Toronto, April 1991).

abolition. A prime Canadian example of that proposition is geographical obstacles. Another is variations in jurisdictions' voter preferences for experimenting with policies, services, and regulation — including those that might attempt to reduce the differences posed by, say, geography and language. Citizens must be able to satisfy their preferences provided there is no discrimination against other Canadian residents in doing so.

Type I Barriers: Explicit Exclusion or Unfavorable Treatment

What I call type I barriers are measures taken by a jurisdiction that explicitly exclude or discriminate against businesses or workers on the basis of where they come from or operate.

A number of barriers of this type exist in Canada. Many are in public sector procurement. Some governments — at all levels: municipal, provincial, and federal — maintain source lists or determine which firms will be invited to bid on a contract in ways that discriminate against suppliers not established in a particular area. Outright local-content requirements also fall into this category. As well, there are instances of both provincial and federal procurement in which "award premiums" are designed to give local suppliers or bidders promising high local content an edge over lower-cost bidders.

Another type I barrier is that created by the quota system for supply-managed commodities. Quotas tend to be allocated by province on a historical or self-sufficiency basis. Thus, there is *de facto* discrimination within each province against efficient producers from other provinces. This practice makes these Canadian industries use more resources than necessary and thus lowers consumers' standard of living relative to what they would enjoy under, say, a system of setting a national quota for each commodity.

Many provinces continue to practice discrimination against out-of-province beer, wine, and liquor. Barriers include preferential listing policies — such as high markups on out-of-province wines —

waiting periods for out-of province listing, packaging requirements, and impediments to marketing.[8]

Other type I barriers include requirements for the processing of some primary products, such as logs and fish, before out-of-province shipment is allowed.

Type II Barriers: Lack of Transparency and Unwarranted Administrative Differences

A second type of impediment to the flow of goods and services is created by administrative measures that lack transparency and by regulatory treatment that differs across provinces — without being justified by differences in voter preferences for specific types of public goods, services, and regulations.

Type II barriers are prevalent in public sector procurement. Even where there are no discriminatory rules regarding the maintenance of source lists, invitations to bid, or contract awards, discretionary actions — such as designs tailored to a local producer — can have the effect of discriminating against out-of-province suppliers.

Type II barriers are also found in the agricultural sector, where various provincial requirements — for example, for packaging, inspection, and certification — hinder interprovincial trade. Indeed, aspects of trucking, financial services, and environmental regulation in Canada are in effect costly impediments to trade; yet alternative solutions exist that would serve the same public purpose at a lesser economic cost.

Type III Barriers: Distortions Unfavorable to One or More Province

Type III barriers are legislative or administrative measures that force or lure to some parts of the country resources that otherwise would

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8 See Canada West Foundation, *The Canadian Common Market*, p. 16, table 7.

have been used more effectively in another province or region; the diversion is accomplished without the political consent of the affected province or region.

These barriers are created by provincial or federal subsidies that demonstrably distort choices of location and production within the country and by national policies that have similar significant regional implications, such as a tariff or the now-defunct National Energy Policy of 1980. Such measures do not create concrete obstacles to interprovincial flows — indeed, they may artificially stimulate these flows by attempting to *lower* natural barriers. The result, however, is the same as that of the other barriers discussed: a suboptimal allocation of resources in the economy.

Many government policies clearly have effects of this type. What is at issue is whether a type III barrier exists as a generally agreed way of fostering the national interest — that is, the regional implications are a secondary consideration, even for the regions involved — or whether a particular province or region negatively affected by the measure is forced to accept it and has no way of recapturing the resources lost to other regions. The latter case, I argue, constitutes a barrier to interprovincial trade.

All three types of barriers can be criticized using efficiency, scale, and dynamism arguments. They may also be harmful from the point of view of equity and/or national unity, since they all constitute instances of economic discrimination by some Canadians against others simply on the basis of geography.

Distinguishing among the three types of barriers is useful, however, because different types of remedies may be suited to each. Removing the first type of barrier usually requires *negative* economic integration — that is, implementing and enforcing measures that forbid explicit discrimination. The second type of barrier lends itself more to *positive* integration, such as making administrative measures more transparent, harmonizing them, or agreeing to mutual recognition. Type III barriers seem to require more systemic changes, such as better regional representation in economic policymaking, to protect potentially affected interests.

Benefits of Removing Barriers

The corollary of the proposition that removing barriers has a net positive effect on the economy is that the existence of barriers impoverishes Canadians in general. Few studies have attempted to estimate the efficiency cost of these barriers to Canadians, but the ones that have done so have concluded that the burden on the economy is important although not overwhelming: about 0.5 to 1.0 percent of gross domestic product (GDP) — some $500 to $1,000 per year per family of four.[9] The significance of this cost can best be appreciated by realizing that it represents a loss for the Canadian economy equivalent to the entire output of Newfoundland every year. As well, these numbers give an idea of the efficiency cost of *existing* barriers. Additional benefits could accrue if one were able to factor in a solution that would prevent the creation of new barriers in the future. Furthermore, the estimates take into account only the static (efficiency) effect of the removal of barriers — that is, the savings that would stem from reallocating existing resources to their most productive use in the economy. They do not attempt to calculate possible economies of scale or the dynamic impact of the removal of barriers on innovation and investment. In Courchene's words:

> One looks at actual interprovincial trade flows to calculate the economic loss generated from various impediments. This is fine as far as it goes. But such an analysis neglects the dynamic efficiency losses. Because the market is fragmented firms may be of less-than-optimal size....There is less reward for innovative behaviour if non-tariff barriers prevent access to larger markets....This is but another way in which the transfer-dependency syndrome impacts on the viability of the domestic economy.... Protectionist measures stifle innovative entrepreneurship and in effect reward complacency, both of which augur poorly for Canada's longer-term international competitiveness. It is diffi-

9 Two of the better-known attempts to estimate the cost of barriers are found in John Whalley, "Induced Distortions of Interprovincial Activity: An Overview of Issues," in Trebilcock et al., eds., *Federalism and the Canadian Economic Union*; and Canadian Manufacturers' Association, *"Canada 1993"*.

> cult to quantify these dynamic efficiency losses, but in my opinion they are every bit as important as the more easily quantifiable static losses.
>
> Another issue is important here....[I]ncluded in the costs associated with internal barriers should be the resource costs [lobbying, advertising, and so on] that are spent in order to obtain or maintain such privileges. Normally, these considerations are excluded in empirical work devoted to measuring the costs of distortions.[10]

It is worth noting that studies by the European Community (EC) Commission and other work on European integration emphasize that the dynamic gains from integration can be quite substantial.[11] The experience of building a single European market seems to confirm that integration has a large effect on firms that is additional to the impact of more efficient reallocation of resources. Although similar gains in Canada might be more modest, it is not inconceivable that the total benefits from removing internal barriers would be as much as 2 percent of GDP.[12]

In essence, internal barriers discriminate against winners, with negative consequences for the competitiveness of the economy as a whole. The impact is magnified by the fact that internal barriers are not evenly distributed across sectors, which might diffuse the overall burden; rather, they affect specific sectors, regions, and firms more

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10 Thomas J. Courchene, "Analytical Perspectives on the Canadian Economic Union," in Trebilcock et al., *Federalism and the Canadian Economic Union*, pp. 95–96. The Canada West Foundation has also characterized lobbying to maintain protectionism as a "significant cost to our economic system" (Canada West Foundation, *The Canadian Common Market*, p. 4).

11 Paolo Cecchini et al., *The European Challenge 1992: The Benefits of a Single Market* (Aldershot: Wildwood House for the EC Commission, 1988). See also European Communities Commission, *Research on the "Cost of Non-Europe": Basic Findings*, vols. 1–16 (Luxembourg: European Commission, 1988).

12 Indeed, economist Michael McCracken, president of Infometrica, has suggested that the gains in the Atlantic provinces could be as high as 3 percent. Quoted by Atlantic Provinces Economic Council (APEC), "Atlantic Economic Cooperation: An Exploration of the Concept, Its Benefits, and Costs" (Background paper prepared for the 1991 Annual Conference of APEC, Dartmouth, N.S., June 11, 1991, Mimeographed).

than others and hence may have a significant negative impact on the emergence of winners in those areas.

A related effect is that barriers can limit opportunities abroad for even the most competitive firms. As the International Trade Advisory Committee (ITAC) explains:

> From an international perspective, interprovincial trade barriers have also been viewed as interfering with international trade between Canada and its trading partners, by restricting the access of imported goods to provincial markets and providing assistance to Canadian exporters. This, in turn, invites retaliatory actions by other countries that limit the access of Canadian goods and services to foreign markets.[12]

Internal trade barriers and external trade interact in other ways as well. Some people suggest that the Canada-U.S. Free Trade Agreement (FTA) has *reduced* the potential benefits of removing interprovincial trade barriers because the gains from trade can now be realized within the broader North American market.[14] But this argument presupposes that the FTA has substantially reduced obstacles to commerce between individual Canadian provinces and the United States in the very sectors affected by Canada's internal trade barriers, giving these sectors an opportunity to rationalize. In fact, in many of the sectors in which internal Canadian barriers remain, full free trade between Canada and the United States has not been achieved by the FTA, thus reducing its possible value as a substitute for lower interprovincial trade barriers.

Furthermore, to the extent that tariffs distorting the regional allocation of resources in Canada may have justified the existence of some regional trade barriers — on the grounds that they would counter

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13 International Trade Advisory Committee, *Interprovincial Trade Barriers*, report of Task Force II (April 1986), p. 2.

14 See Pierre-Paul Proulx, "Primary and Secondary Trade between Canada and the United States: A National, Regional, and Provincial Overview with Particular Reference to Interregional Trade in the Borderlands," Cahier 9038 (Montreal: Université de Montréal, Département de sciences économiques, December 1990).

the tariffs' negative regional impacts — the lowering of these tariffs under the FTA and the General Agreement on Tariffs and Trade (GATT) now makes these barriers more costly, not less.

Assessing expectations of gains from more open trade must also take into account the structure of the markets in the industries and regions affected by the existence of barriers. It might be that the removal of barriers would allow one firm to dominate its industry, perhaps on a regional basis, which would negate the competition-based arguments advanced for freer trade in the first place.[15]

This concern is, in principle, valid. Indeed, market integration in Europe was accompanied by strengthening competition law at the EC level. Canada, however, already has legislation that addresses anticompetitive behavior. The Bureau of Competition Policy, which enforces it, could be directed to be on the lookout for anticompetitive practices arising from the removal of barriers to trade.

The most important benefit of all from the reduction of trade barriers within Canada might be increased certainty that current beneficial economic links will not be severed. An enormous part of our economic well-being is derived from the existing flows of goods, services, labor, and capital within Canada.[16] Ensuring formal mechanisms aimed at forbidding internal trade barriers would better secure these current benefits. This consideration is particularly important in the context of today's recurring discussions that may lead to some political decentralization. Many Canadians, perhaps particularly those in the smaller provinces, would put considerable value on knowing that new arrangements would not be allowed to entail *new* provincial trade barriers that could decrease their ability to move in search of better oppportunity in a chosen career or further restrict their access to the entire Canadian market.

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15 For an example concerning trucking in New Brunswick, see Michael Bradfield, *Maritime Economic Union: Sounding Brass and Tinkling Symbolism* (Ottawa: Canadian Centre for Policy Alternatives, 1991), p. 5.

16 See Canada, Department of Finance, "Economic Linkages among Provinces," *Quarterly Economic Review*, March 1991, pp. 34–54.

Why Do It Now?

As noted in the introduction, although the principle of strengthening the economic union is not very controversial, the way in which it should be implemented is bound to touch on the sensitive issue of the proper balance of powers within the federation. Thus, one can ask whether the middle of a constitutional crisis is the proper time for trying to strengthen the Canadian economic union.

In my view, just as the opportunity to bring the provinces closer together economically in 1867 found expression in the creation of a new political link, proposals for a stronger economic union probably have an enhanced meaning as part of the current attempt to unite the country politically. This point echoes the links drawn between economic and political union by the Pepin-Robarts Task Force and the Macdonald Commission.[17] Far from muddying the waters, properly designed measures to strengthen the economic union could offset other forces in the country that are threatening a fragmentation detrimental to standards of living across Canada.

Previous Proposals for Freeing the Canadian Internal Market

The strengthening of Canada's economic union has been the subject of an ongoing debate in recent years. Some commentators simply explain that barriers are costly and should be removed. Others go further, saying that mobility rights, which are at the core of an economic union, should be more firmly entrenched in the Constitution. Still others propose elaborate mechanisms to deal with the more subtle forms of barriers to trade within Canada.

None of the various mechanisms and procedures for removing barriers recommended in various reports has been adopted, al-

17 Canada, Task Force on Canadian Unity, *A Future Together: Observations and Recommendations*, chaired by Jean-Luc Pepin and John P. Robarts (Ottawa: Supply and Services Canada, 1979); and Canada, Royal Commission on the Economic Union and Development Prospects for Canada, *Report*, chaired by Donald Macdonald (Ottawa: Supply and Services Canada, 1985).

though an intergovernmental Committee of Ministers on Internal Trade was formed in 1987. Over the years, the committee has succeeded only in removing some of the barriers existing in the beer industry and in public sector procurement, and even this limited progress was achieved in an *ad hoc* fashion. Many of the proposals made over the past ten years or so are, therefore, still relevant for what they can suggest today. Some of the most prominent ones are examined in some detail below.

Before the Constitution Act, *1982*

Two sections of the *Constitution Act*, 1867, attempt to reduce trade barriers. Section 121 states: "All articles of the Growth, Produce, or Manufacture of any one of the Provinces shall, from and after the Union, be admitted free into each of the other Provinces." Despite its sweeping tone, this section has proven of limited use, partly because it does not deal effectively with restrictions other than tariffs.

Section 91 extends the exclusive legislative authority of the Parliament of Canada to the regulation of trade and commerce, among other sectors. The courts, however, have not interpreted this section as extending the federal jurisdiction to trade within a province, which means it cannot be used to strike down a number of barriers. Overall, it has also been difficult to extend the application of either section 121 or 91 to all aspects of government intervention, such as administrative practices.

During the years leading to the patriation of the Constitution, observers suggested a number of changes aimed at strengthening the Canadian economic union. In particular, the Task Force on Canadian Unity, the Canadian Bar Association, and other consultative groups and experts recommended that provisions be made in the Constitution regarding the mobility of services and capital. These proposals were not adopted as part of the constitutional amendments of 1982, although section 6 of the new Canadian Charter of Rights and Freedoms did proclaim the existence of mobility rights for individuals, subject to some limitations.

The Macdonald Commission

The Royal Commission on the Economic Union and Development Prospects for Canada, chaired by Donald Macdonald, naturally addressed the issue of economic union and thus the issue of interprovincial trade barriers. Regarding the latter, the commission recommended that Canadian governments adopt a detailed code of economic conduct. It recommended against constitutionalizing such a code, however, because "the exercise would almost certainly founder in the constitutional amendment process" and it would also make it difficult to adapt the code to changing circumstances. Furthermore, "a constitutionalized code formulated today would probably include so many opting-out, *non obstante* and exemption clauses that it would perhaps only legitimize what it was designed to prevent."[18]

The commission saw the code as being initiated by a federal-provincial council of ministers. It would spell out the principles of an economic union — which could later be entrenched in the Constitution — and identify and describe practices that were and were not acceptable at both the federal and provincial levels. Enforcement would be carried out with the assistance of a commission on the economic union, made up of independent experts, which would

> have responsibility for preparing materials for the Council as directed; initiating research to explore the state of the economic union and methods for improving it; receiving complaints from private actors, including groups, individuals and corporations affected by government actions which threaten the economic union; investigating and reporting on such alleged actions, and making recommendations to the public and the ministerial council.[19]

The commission would eventually take a more formal adjudicative role in matters pertaining to the economic union, replacing the courts

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18 Macdonald Commission, *Report*, vol. 3, p. 137.

19 Ibid., p. 139.

in these matters, although the report said that the "essentially political process" of balancing objectives of economic union against "other goals" should be left to the council of ministers.[20]

The International Trade Advisory Committee

An ITAC task force released a report on interprovincial trade barriers in April 1986. It suggested continuation of intergovernmental consultation aimed at "increasing" interprovincial trade and development of a process by which "interprovincial barriers to trade could be reduced and removed through formal federal-provincial agreements."[21]

On a more practical note, ITAC also recommended a phased removal of barriers, the establishment of formal measures to prevent their reimposition in the future, and the institution of appropriate transitional policies designed to minimize the adjustments required of government, business, and labor. The phasing-out of barriers need not be applied uniformly across sectors and regions, it suggested, and regions and industries benefiting from the changes should contribute financially to the transitional measures.

Finally, ITAC suggested that removing interprovincial trade barriers could benefit Canadian firms by enhancing market access to the United States, if Canada could obtain reciprocal U.S. action.

The Canada West Foundation

In a 1989 publication, the Canada West Foundation (CWF) recommended the creation of an interprovincial trade commission — as it had in another study in 1985.[22] The advantages of such a commission, which would overview and regulate interprovincial trade mat-

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20 Ibid.

21 International Trade Advisory Committee, *Interprovincial Trade Barriers*, p. 48.

22 Canada West Foundation, "Time for Action: Reducing Interprovincial Barriers to Trade," in *Western Perspectives* (Calgary, May 1989); and idem, *The Canadian Common Market*.

ters, were seen as minimizing the extent to which all governments could be pressured by vested-interest groups, forcing governments to consider the implications of their policies on other Canadians, and providing a forum for discussion and negotiation that would facilitate the dismantling of natural or unintentional barriers to trade in Canada. It was recommended that each province be represented on the commission so that "the right of provincial economic self-determination would be upheld."[23] A formal procedure for conflict resolution that would minimize retaliation and hence limit escalation in the number and severity of barriers.

The CWF also recommended the adoption of national labor standards, a change in discriminatory markups and licensing practices in provincial liquor regulations, subsidy cuts — subject to remaining competitive *vis-à-vis* the United States — a review of agricultural support, and, if action at the national level proved too slow, regional trade initiatives.

The Canadian Manufacturers' Association

In April 1991, the Canadian Manufacturers' Association (CMA) introduced its "Canada 1993" plan for the creation of a single economic market in Canada.[24] It was essentially a schedule for consecutively eliminating interprovincial barriers in seven areas: provincial and federal goods procurement; trade in beer and wine; government procurement of services and construction; goods, services, and construction procurement by federal and provincial Crown corporations, including electric utilities; goods, services, and construction procurement by subprovincial organizations that benefit from provincial transfers — that is, the MUSH sector: *m*unicipalities, *u*niversities, *s*chools, and *h*ospitals; the labor market; and agricultural products. The CMA made no proposal for a specific institutional structure that would promote these changes.

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23 Canada West Foundation, "Time for Action," p. 14.

24 Canadian Manufacturers' Association, "*Canada* 1993".

The Atlantic Provinces Economic Council

In a report released in June 1991, the Atlantic Provinces Economic Council (APEC) came out greatly in favor of stronger regional economic (but not political) integration and cooperation.[25] It suggested a formalization of existing networks that deal with the matter at the political and official level. As well, it recommended that arm's-length commissions or agencies, insulated from political interference, become part of the decisionmaking process. APEC proposed giving priority both to relatively easy tasks — such as harmonizing transport regulations — and to more complex areas in which it expected substantial benefits, such as government procurement.

The Federal Government's 1991 Proposals

The federal government's proposals regarding the economic union, released in September 1991 as part of a broader package of suggested constitutional changes, tackled the issue of the strengthening of the internal market in two ways.

First, Ottawa proposed that section 121 of the Constitution be modified so as to: (1) specifically include services, persons, and capital, as well as goods, in a "free movement" provision; (2) specify that the provision applied to both tariff and nontariff barriers; (3) clarify that it applied to barriers created by provincial as well as federal governments and to barriers resulting from legislation, regulation, or administrative practice. Thus, the proposed conditions were to be binding on all governments, and private citizens could apply to have provincial or federal measures overturned by the courts on the basis of their contravening section 121. Specified exceptions would prevent the revised section from being used to invalidate federal laws enacted to further equalization and regional development, provincial laws enacted to reduce disparities between regions within a province, or laws that Parliament declared to be in

25 Atlantic Provinces Economic Council, "Atlantic Economic Cooperation."

the national interest and that were approved by at least seven provinces representing at least 50 percent of the population.

The second proposal was that an additional section 91(A) vest Parliament with a new power to "enact laws for the efficient functioning of the economic union in areas beyond its present competence." Any law passed as a result of this new power would, however, become valid only with the approval of two-thirds of the provinces representing at least 50 percent of the population. A dissenting province could, with 60 percent approval in its own legislature, stave off the application of the new law on its territory for a period of three years — whether this opting-out would be renewable or not remained to be specified. Once approved by a province, the measures would become permanently binding.

These proposals encountered fierce resistance in the months following their release. Many people saw them as too sweeping, leaving little room for weighing in the social impact of removing some barriers, and as instituting a coercive mechanism whereby the federal government and some provinces could dictate policy to another province in any area deemed to affect the efficient functioning of the union. Even strong supporters of unadulterated free trade among the provinces did not find the proposals satisfactory. They thought that entrenching exceptions in section 121 would leave federal, provincial, and local authorities too much discretion to contravene the general nondiscrimination principle and that the opting-out provision in section 91(A) could entrench, rather than help smooth out, a Canadian economic mosaic.

Faced with these objections, the Special Joint Committee on a Renewed Canada, established to make recommendations to Parliament on the federal government's proposals for a renewed Canada, concluded in February 1992 that a new section 121 should declare Canada to be "an economic union within which goods, services, persons and capital may move freely" and go on to prohibit "any prohibition or restriction...based on provincial or territorial boundaries [that] constitutes a means of arbitrary discrimination or a disguised restriction of trade across provincial or territorial bound-

aries."[26] There would be specific exemptions for federal laws enacted to further the principles of equalization or regional development and for provincial or territorial laws enacted to reduce disparities within that province or territory. Additional exemptions were proposed for any law enacted for public protection, safety, or health, for the functioning of existing or new government-owned monopolies, and for the preservation of marketing boards. (The last three exemptions were meant to replace the much-criticized blanket "national interest" exemption contained in Ottawa's 1991 proposals.)

In addition, the committee has recommended that the new section 121 entrench a commitment by federal, provincial, and territorial governments to seek agreement on equivalent national standards to "enhance the mobility of persons and further the well-being of Canadians" and that recognized experts, rather than the courts, deal with mobility-related disputes through a new dispute settlement mechanism.

The February 1992 proposals also called for part III of the *Constitution Act*, 1982, titled "The Social Covenant and the Economic Union," to include a commitment by governments and legislatures to the "free movement of persons, goods, services and capital" and a provision to establish an intergovernmental agency to "review, assess and report" on the performance of these governments in meeting these objectives.[27]

What Is Being Done

Meanwhile, some action been attempted within the existing framework. In November 1987, the first ministers established an intergovernmental Committee of Ministers on Internal Trade. So far, it has hammered out two agreements to reduce internal trade barriers, one on beer marketing practices and another on government procure-

26 Canada, Parliament, Senate and House of Commons, Special Joint Committee on a Renewed Canada, *Report*, chaired by the Hon. Gérald A. Beaudoin and Dorothy Dobbie (Ottawa: Supply and Services Canada, 1992), p. 121.

27 Ibid., pp. 122–123.

ment practices.[28] Also, the Western provinces and the Maritimes have signed regional agreements on government procurement.

As the examination of these agreements below shows, all of them have a number of shortcomings and may only dent interprovincial barriers to trade.

Beer Marketing

The Intergovernmental Agreement on Beer Marketing Practices came into force in January 1991. It commits the parties to "eliminate any policies or practices, laws or regulations that discriminate against the sale of Canadian beer and beer products based on province of origin" (section 3). Discriminatory listing practices were to be eliminated by the end of 1991, and discriminatory pricing practices by the end of 1994. Other discriminatory practices (for instance, in distribution) are to be dealt with by a technical committee, which is to report in January 1993.

The agreement provides a dispute-settlement procedure, which includes the use of a panel of "neutral and qualified" individuals. This mechanism is, however, available only to parties to the agreement, not to private interests.

Any participating government can withdraw on six months' notice, and the agreement ceases to be in force if the parties to it do not represent at least 80 percent of the Canadian market. Manitoba, New Brunswick, Newfoundland, and Nova Scotia did not sign the agreement.

In March 1992, the Ontario government offered to open that province to beer produced in any other province on condition of reciprocal access. (A minimum price, it appears, would still be in effect for all brands.) This offer came as Canada was looking for ways

28 On May 1, 1992, the committee agreed that the elimination of remaining barriers to interprovincial trade should be based on the three principles of nondiscrimination, reconciliation of standards and regulations, and adherence to administrative practices that provide for free mobility. Each government is to report on how it applies these principles, with a view to agreeing subsequently on a work plan to remove all barriers by March 31, 1995.

to comply with a GATT panel's decision that it should dismantle barriers against foreign beer. Compliance would make restrictions on foreign beer less onerous than those on out-of-province beer, which prompted acceleration of the barrier removal process within Canada.

Government Procurement

In November 1991, the first ministers issued the Intergovernmental Agreement on Government Procurement. It prohibits in principle procurement practices based on anything other than price, quality, quantity, delivery, and servicing capabilities for contracts of more than $25,000 — the threshold amount is to be increased each year by an inflation index. A major part of the agreement is concerned with defining and implementing open tendering procedures. Participating governments, including the federal government, may postpone implementing the agreement until January 1, 1996, although they are required to immediately file a detailed report on exceptions.

The deal extends to all goods, but not to services or construction — although there is provision to begin negotiations on extending it to these areas. Neither does it apply to the MUSH sector or to Crown corporations, which together account for more than 60 percent of public-sector procurement in Canada.

Unlike the beer marketing agreement, the public procurement agreement establishes no dispute settlement mechanism. Furthermore, Quebec has not formally signed on, although it has agreed to the package in principle.

Regional Agreements

Two regional procurement agreements are in place, partially opening the government procurement market among their signatories. The Western Agreement on Procurement came into effect in April 1989, followed in April 1990 by the Maritime Procurement Agreement. Like the national accord on procurement, which followed and

to some extent superseded these two regional agreements, they exclude Crown corporations and the MUSH sector. Both do apply to services and construction contracts, although there are a number of exemptions. Neither provides a mechanism for direct complaint by individuals or companies hurt by procurement practices.

Although the idea of regional trade liberalization seems attractive when national liberalization is lagging, it not evident that pursuing regional agreements is in the interest of Canada as a whole. In fact, it could divert existing trade between two provinces. Consider, for instance, the following hypothetical situation. A producer in Ontario supplies the government of Newfoundland with widgets despite the latter's 10 percent "award premium" favoring local suppliers. The contract has been awarded because the Ontario producer is more efficient than its competitors in any other province and at least 10 percent more efficient than widget producers in Newfoundland. Then suppose Newfoundland signs on to the Maritime agreement on the mutual liberalization of public procurement. Even if a producer in Nova Scotia is, say, 9 percent less efficient than the Ontario producer, it will now get the Newfoundland contract. Trade has been diverted away from the most efficient source in the country. Newfoundland's taxpayers would now pay *more* for their widgets, and the economy in general would suffer a loss of efficiency — possibly tempered by greater economies of scale and dynamism for the Nova Scotia firm. It is debatable whether this situation occurs often in practice, but the example illustrates the danger: selective liberalization could, in effect, carve up the economic union.

Market Integration Elsewhere

Other parts of the world have dealt or are now dealing with the issues of integrating into a more efficient market. Although Canada's situation is unique, the country can learn much by examining these other experiences, particularly the recent efforts of the EC and Australia to create or strengthen internal markets.

The European Community

Many people see the "Europe 1992" program not only as an important stepping stone to closer economic and political union but also as a working example of decentralized federalism. For decentralists and even separatists, the European experience shows that sovereign states can work toward a single market. For others, it is a clear sign that federalism is the way of the future.

The lessons to be drawn from the current and probable future structure of the EC are probably limited for Canada. "Europe" is — and for the foreseeable future will remain — not so much a representative government as a "club" of states. Decisions are not made by the European Parliament but by the Council on which European heads of government — or their ministers, when sectoral issues are being considered — sit and are apportioned one or more votes depending on the issue at hand. The budget represents a very small proportion of the EC's GDP, and most it is used for the Common Agricultural Policy. The EC has no exclusive jurisdictions; competence in a particular matter is handed over by member states to the higher order of integration. Even then they do not relinquish all control; they simply agree that decisions on a particular matter of common interest should be taken at a collegial level rather than at an individual one. This structure effectively ensures that the principle of subsidiarity will apply: only what needs to be handled at the EC level will be given to it.[29]

Despite these structural differences, it is interesting for Canadians to look at the process of "Europe 1992," which is finally achieving the trade barrier removal sought since 1958. Much of the exercise's success — relative to that of previous attempts at European economic integration — has come from the very process chosen, a process that has involved a number of specific steps and conditions.

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29 If the European Parliament, rather than the member states themselves, had control over EC legislation, more powers would doubtless have been transferred to EC institutions.

First, a plan was proposed to eliminate about 300 precisely identified barriers to a true single market.[30] Second, the objectives embodied in that plan were adopted by the EC Council in the *Single European Act*, using the unanimity rule, and the EC Commission was mandated to propose a detailed directive for each barrier to be removed. (An EC directive becomes operational within a member state only when all relevant domestic legislation has been modified to conform with that directive.) Third, the *Single European Act* altered voting procedures in the Council so that a only a qualified majority would be required to pass the directives related to "Europe 1992."

It was agreed that the overriding concern was to avoid wholesale reregulation or the emergence of new layers of state intervention beyond what was necessary to create a borderless market. Therefore, a wide variety of tools were used in drawing up the directives. In some areas, minimum or common European standards for goods and services were deemed necessary — for example, for reasons of health or to maintain prudential standards in banking. Where appropriate — for example, in telecommunications — industry itself was mandated to devise the standards, via the European Industry Roundtable system. Beyond this, however, the directives apply the concepts of mutual recognition and home country rule — in other words, firms can operate across the EC on the basis of what is acceptable in their home country. Public sector policies were geared to the new objectives. An open procurement process was mandated for governments and publicly owned enterprises. The Commission was given more effective powers to obtain rollbacks of state subsidies aimed at shoring up companies when these support payments are deemed harmful to European industry as a whole. Decision-makers are now working on fiscal harmonization, in particular of value-added tax rates and corporate taxes and on new documentation and security procedures, which together will remove the need for border checks.

30 European Communities Commission, *Completing the Internal Market: White Paper from the Commission to the European Council* [the Cockfield Report] (Luxembourg: European Commission, 1985).

Finally, the EC took a number of "parallel measures" — measures not directly dealing with trade barriers but deemed necessary for a more efficient functioning of the new single market. Among them were transferring antitrust investigation of sizable companies from the national to the EC level and doubling the EC structural fund aimed at regions that would initially suffer from the removal of barriers.

The example of EC economic integration is a recurring theme in the current Canadian constitutional debate.[31] Yet not all aspects of European integration can automatically apply to Canada. In addition to differences in political structure, there are differences between the pattern of intra-EC trade flows and that of interprovincial Canadian trade (see Table 1). Although Europe's large domestic markets result in internal trade that is a smaller percentage of GDP there than in Canada, other indicators suggest that the European economies are more closely intertwined than are those of the Canadian provinces. Internal EC trade is a greater (and growing) portion of exports for member countries than interprovincial trade is for Canadian provinces. Removing the Ontario-Quebec trade relationship, for example, would make a much bigger dent in Canadian interprovincial trade figures than would removing any single relationship within intra-European trade. Furthermore, the average European lives in a country with more land borders with another EC member state than with nonmembers, whereas the average Canadian lives in a province with more land borders with U.S. states than with other Canadian provinces. This last fact suggests that such proposals as harmonizing sales taxes in Canada along the European model[32] may not be suitable.

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31 See, for example, Thomas J. Courchene, *In Praise of Renewed Federalism*, The Canada Round 2 (Toronto: C.D. Howe Institute, 1991), pp. 5–7; G. Bruce Doern, *Europe Uniting: The EC Model and Canada's Constitutional Debate*, The Canada Round 7 (Toronto: C.D. Howe Institute, 1991); and Peter M. Leslie, *The European Community: A Political Model for Canada?* (Ottawa: Supply and Services Canada, 1991).

32 As proposed, for instance, by Samuel Slutsky, "Genuine Free Trade May Hinge on Tax Regimes," *The Financial Post* (Toronto), February 13, 1991.

Table 1: ***The Structure of Trade within the European Community and within Canada***

	European Community	Canada
Internal trade as % of GDP (1984)	13.5%	18.7%
Internal trade as % of total exports (1984)	53.9%	44.4%
Excluding largest internal relationship	48.9%	32.2%
Internal trade as % of total exports (1990)	60.7%	n.a.
Average number of neighboring members (provinces)	2.8	2.1
Average number of neighboring nonmembers (states)	1.7	2.9

Sources: *International Financial Statistics* and *Direction of Trade Statistics* (International Monetary Fund); Canada, Department of Finance; and author's calculations.

Australia

Three portions of the Australian constitution are pertinent to a discussion of domestic trade. One is section 92, which says, "Intercourse among the states...shall be absolutely free." Although this guarantee has been interpreted as encompassing capital, persons, and some services, in addition to goods, its reach has been limited to preventing state or Commonwealth measures that might directly affect interstate trade. Measures creating obstacles indirectly are not, in practice, touched by section 92. Second, section 99 says the federal government may not "by any law or regulation of trade, commerce, or revenue, give preference to one State or any part thereof over another State or any part thereof." Finally, the Australian constitution gives the federal government power to regulate in matters concerning interstate and international trade and commerce, which has led to federal involvement in competition law, securities regulation, and industrial disputes of a national scope.[33]

33 Some of the material on Australia, the United States, and Germany was taken from Canada, Department of Justice, *Securing the Economic Union in the Constitution* (Ottawa: Supply and Services Canada, 1980); and Warren F. Schwartz, "Regulation of Industrial Subsidies in the EEC, the United States, and GATT," in Trebilcock et al., eds., *Federalism and the Canadian Economic Union*, pp. 415–420.

Despite this constitutional favoring of a strong economic union, key state-regulated areas, such as transportation, display many differences that have proved obstacles to an efficient internal market. Of this situation, the Macdonald Commission report commented:

> Countries like Australia, with very strong constitutional rules governing the common market, have found governments at both levels frustrated. However wise, judges are ill-equipped to make...trade-offs. They must decide whether a given act is right or wrong: they cannot easily suggest compromises or alterations in the policy.[34]

In an attempt to counter these shortcomings, the federal and state governments agreed in July 1991 to eliminate certain trade barriers within the broader context of "reforming intergovernmental relations." Leaders from both levels of government concurred that it was "essential to overcome the regulatory differences that needlessly inhibit interstate mobility of goods and labour" and agreed "in principle on models for implementation of mutual recognition for both goods and occupations...where uniform national standards are not essential."[35]

Although further discussions are anticipated after working groups report on some technical aspects of integration and more consultations are carried out, this opening of Australia's internal market is expected to be implemented in early 1993.

The United States and Germany

In considering federations, observers generally agree that the constitutions of the United States and Germany provide for stronger economic integration than those of Canada and Australia.

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34 Macdonald Commission, *Report*, vol. 3, p. 137.

35 Australia, Special Premiers' Conference, "Communique," Sydney, July 30, 1991, p. 6.

The U.S. constitution has only three explicit provisions that apply to the establishment of an economic union. Essentially, the first two forbid one state to discriminate against citizens of others and guarantee the right to move freely throughout the country. As a result, differences between state residents and nonresidents can apply for any given policy only when there is a compelling reason (for example, administrative reasons) and when no less restrictive alternative is available.

More important, however, is the commerce clause, which gives Congress broad legislative power over activities within a state insofar as they are deemed to affect interstate commerce. The scope is much wider than the interstate commerce powers of the Canadian or Australian federal governments. The U.S. clause has been interpreted as forbidding states to place a "burden on interstate commerce,"[36] implying that Congress can override state laws if they are deemed to impede interstate trade. In such a system, the country's majority could easily overrule any state or regional initiative, since each state holds only 2 percent of the votes in the U.S. Senate.

The German constitution gives the federal government very wide powers to legislate for the "unity of customs and commercial territory" and "the exchange of goods," as well as to interfere in legislation and regulation of an individual *Land* (state) if it interferes with the interests of other *Länder* or of Germany as a whole. Federal legislation is subject to approval by an upper house whose members are appointed by *the Länder* — in other words, party composition in the upper house changes each time a new *Land* government is elected. The *Länder* are represented in the upper house in proportion to their population, although small *Länder* have a minimum number of seats.

Two Different Approaches

The differences between the U.S. and German systems on the one hand, and the integrating mechanisms set out for the EC and Aus-

36 As quoted in Canada, Department of Justice, *Securing the Economic Union*, p. 14.

tralia on the other, are instructive. In the former cases, the parties to the union are obviously comfortable enough with the political process and the way it represents them at the center to allow federal institutions to override state policies: not only those that contravene the constitution — which the courts could take care of in any event — but also those that are incompatible with the broad economic policy outlines established by the federal government.

The EC and Australia, by contrast, have less settled centralized systems. In attempting trade liberalization in each case, it was first important to reach unanimous agreement on the areas to be addressed and the principles on which to proceed; once these were established, unanimity was not required on all the technical details, which could be delegated to experts. The evidence from these two experiences also suggests that discussion on an entire package encourages compromises that might not be made if each barrier to trade is discussed separately. It also seems significant that the process chosen, where possible, was one of mutual recognition of regulations, rather than uniformity, which would be a natural choice for a centrally controlled economic integration.

Some Operational Principles for a Strengthened Economic Union

The facts and ideas presented so far suggest a useful set of operational principles to ensure the mobility of goods and services within the Canadian economic union.

1. There seem to be two ways of improving the functioning of an economic union. One is to use strong powers at the center — either the courts or a political majority in the legislature — to overturn local legislation or policies that inhibit trade and commerce within the union. Another uses agreements that respect the existing legislative competence of the governments involved but that have all governments undertaking to implement and comply with mutually agreed measures. The question then becomes how such an agreement can be reached and enforced.

2. Whichever path is chosen, economic unions strive to apply strong safeguards to prevent explicit economic discrimination by one part of the union against interests located in other parts. Not having to face type I barriers becomes a fundamental citizenship right of the union, one with which all levels of government must comply.

3. The recent Canadian approach of step-by-step removal of barriers via intergovernmental agreements does not seem to be the way to eliminate unnecessary barriers to trade quickly and thoroughly. Considering sectors one by one limits the possibilities for tradeoffs; hence only limited deals are reached. In comparison, the recent European and Australian approaches suggest that an efficient way to remove internal barriers is to proceed by addressing a whole package of barriers.

4. Again looking at Europe and Australia, it seems that the broadest possible consensus on principle — in both cases, unanimity was reached — is necessary when contemplating which barriers should be included in the package. Detailed implementation, however, can be left to a specialized institution, with each technical measure subject only to approval by a large majority of a deciding body. A strong commitment to the package and to the process is needed, however, before the experts can produce concrete results on a range of specific barriers.

5. In the examples examined, the problems of economic union have been worked out among governments without the formation of new elected bodies or the delegation of additional powers to existing bodies. Thus, to the extent that the EC is experiencing a "democratic deficit,"[37] it has not been detrimental to reducing intra-Community trade barriers and may in fact have helped.

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37 In Europe, the term "democratic deficit" refers to the pooling of national sovereignty at a level at which decisionmakers are not directly accountable to the voters. See "My, How You've Grown," *The Economist*, January 25, 1992, pp. 49–50.

6. Achieving the necessary consensus requires addressing reasonable objections to the removal of barriers. This *desideratum* implies more regional input into or veto over policy than simple representation by population provides. It also means strengthening the role of competition policy, revamping structural policies for certain regions, and possibly providing adjustment periods. Another possibility is grandparenting clauses — such as "Europe 1992" used for British-content requirements for North Sea oil drilling.

7. Apart from the few exceptions described, which are meant to provide maximum flexibility, there are virtually no examples of jurisdictions' being allowed the option of partially opting out of an economic union.

8. In the European and Australian models, the reduction of type II barriers was achieved in part by agreed-on harmonization of standards, but only where there was a demonstrated need — for example, for reasons of health, safety, or transparency. Where harmonization was not deemed necessary, automatic and mutual recognition of standards and practices was enshrined as a way of opening markets and ensuring continuing competition for ideas among governments. The European experience also suggests that industry can be usefully involved in the exercise.

9. Canadians should be careful in calling for full harmonization of policies incidental to the mobility of goods and services, because individual provinces are exposed to very significant competition with individual U.S. states. For example, there is probably a less compelling need for the harmonization of sales taxes in Canada than there was in Europe.

Conclusion and Recommendations

One fact must inform discussions on the Canadian economic union: Canada is a federation of provinces that have an equal degree of legitimacy but are widely disparate in interests, level of development, and size of population. This fact affects both the type of economic arrangements that Canadians might consider optimal and the process by which they can get there.

For such a country, the center alone cannot decide what is best for the economic union. This is true regardless of whether small provinces and regions are more or less well represented at the center. If the small provinces are overrepresented, a few of them can dictate in an undemocratic way that the resources of larger provinces be redirected toward them. If they are represented according to population, they ultimately have no power to disallow laws and policies that they feel discriminate against them.

Thus, it is inevitable that a permanent strengthening of the Canadian economic union be accomplished through a form of direct cooperation between Ottawa and the provinces. But since such a formula has not been adequate in the past, the mandate and mechanics of federal-provincial discussions need to be revised. In light of this challenge and based on the principles listed in the previous section, I recommend that the following be implemented to strengthen and complete the internal Canadian market:

Remove Type I Barriers to Interprovincial Trade

1. Section 121 of the Constitution should be improved with the explicit aim of removing discriminatory barriers to commerce and to the earning of a livelihood that is based on provincial or territorial boundaries. (Notice that this approach differs from providing a blanket guarantee of mobility, which is what the federal government proposed in September 1991.) Discrimination would be defined as

anything that prevents nonresidents from enjoying the same commercial or employment conditions as those offered to the vast majority of residents in a province or territory. This constitutional change would suffice for the removal of type I barriers and make the section's application clearer and more consistent with the concept of nondiscrimination as a right of citizenship. It would also avoid the need for exceptions — since the wording would make it clear that the revised section did not apply to regional development or equalization.

2. Existing requirements for *provincial* content and processing should be changed to requirements for *Canadian* content and processing. Certain projects could be allowed to have *local*-content and/or *local*-processing requirements that are well defined and limited. This approach would allow smaller provinces to maintain an advantage over large ones in some cases, since local content for the former is often not very different from provincial content.

3. The Bureau of Competition Policy should be required to monitor and be adequately provided to deal with any lessening of regional competition arising as a result of the removal of barriers. This mandate could be accomplished by a regular report to Parliament and the provincial legislatures for a period of time following the adoption of a new section 121.

Remove Type II Barriers to Interprovincial Trade

1. The powers to declare laws needed for the efficient functioning of the economic union should be made explicitly concurrent, perhaps under section 95 of the Constitution. The Constitution should also mandate joint provincial-federal meetings to exercise this power.

2. The removal of type II barriers should be carried out jointly by both levels of government in a two-stage process. First, after adequate consultation, the federal government and the provinces should

be presented with a package of objectives. The aims specified should include:

- Removing or adequately modifying provincial and federal measures incompatible with the new section 121.
- Devising an enforceable code of conduct, transparency, and information regarding all public sector procurement. As recommended by the Canadian Manufacturers' Association, the statutes of Crown corporations should be amended to ensure that they conduct procurement along guidelines agreed to by governments.
- Making the system of marketing boards — insofar as it survives the Uruguay Round of GATT negotiations — more responsive to comparative advantage among provinces.
- Apply mutual recognition of standards, rather than uniformity, wherever possible. This approach would provide governments the maximum flexibility to experiment with policies and delivery mechanisms, without creating new barriers to trade.

There should be one vote on the whole package in principle, and there should be no possibility of opting out once it has been approved. But what should be obtained is the *unanimous* approval of all 11 governments.

3. The second stage of the process should start with delegation of the drafting of individual technical measures to a team of federal and provincial experts, only some of whom would be direct representatives of the federal and provincial governments. Individual measures should be approved by a "qualified two-thirds majority" vote of the provinces (see point 5 below).

4. The team of experts should also examine, case by case, the need for structural help for communities directly affected by its proposals. Funding could be provided by very small surcharges on public sector purchases.

5. So as to avoid requiring the automatic approval of either Quebec or Ontario, a major hurdle to dealing with regional grievances, votes should be decided by a "qualified two-thirds majority" defined as 19 (two-thirds) of 28 votes distributed as follows: Quebec and Ontario, four votes each; Alberta and British Columbia, three votes each; Newfoundland, Nova Scotia, New Brunswick, Manitoba, and Saskatchewan, two votes each; and Prince Edward Island and each of the three territories, one vote each.[38]

Remove Many Type III Barriers

1. Although there is no compelling reason for the removal of all provincial and local subsidies, a code should be established prohibiting one province from harming other Canadian jurisdictions via a subsidies policy. Tests of unreasonability and/or reasonability should be agreed on. (One test of unreasonability could be whether an industry is already well established in another province and stands to be hurt by the subsidies. A test of reasonability could be whether the lack of a subsidy makes a local industry uncompetitive *vis-à-vis* U.S. firms.) This approach should break down some type III barriers.

2. Any government should be able to bring before its peers measures that it considers to be type III barriers, including federal policies or decisions deemed to discriminate against some province or region. Unless such a measure could garner the approval of a "qualified two-thirds majority" of provincial representatives (see point 5 above) as being compatible with the efficient functioning of the economic union, the party responsible for the measure would have to modify it.

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38 This system was inspired by the EC weighted-voting system, which respects orders of magnitude in population in the ordering of voting weights but not in the weights themselves.

Establish an Internal Trade Tribunal

An internal trade tribunal should be set up to hear cases regarding section 121, all measures to remove type II barriers, and subsidies tests. This tribunal, composed of experts and a technical staff, would be empowered to hear trade complaints from either governments or individuals regarding the functioning of the economic union. Even if decisions are appealed before the regular courts, the work of the tribunal would have greatly facilitated the work of the court.

* * *

Together, these measures would go a long way toward creating a Canadian internal market that was truly free of barriers, while ensuring that local initiative, flexibility in policy implementation, and correction of unwanted effects are considered integral parts of the process. The proposals would thus improve Canadians' economic well-being, while respecting the nature of the Canadian federation and the diverse needs of the various parts of the country.

Efficiency, Capital Mobility, and the Economic Union

David M. Brown

In the current round of constitutional debate, the federal government has set a high priority on entrenching protections for the economic union.[1] What is sought is entrenchment of what are often called the four economic freedoms — the right of free movement of goods, of services, of people, and of capital.

The desire to modernize the Constitution's existing economic statements on the union has been around for a long time. The present impetus seems to have two roots. One is the desire for a renewed but more decentralized federation; in the federal government's view, greater political power in the provinces should be offset by increased protection of free movement in order to protect the integrity of the economic union. The second rationale used by the federal government for entrenchment is to support and enhance the efficient functioning of the economic union.

The prospect of political decentralization combined with more efficient functioning of the economic union has fanned concerns among many Canadians about jobs, social policies, and the country's institutions. Uncomfortable with abstract notions from economic theory, these and other Canadians have asked: What is efficiency?

I thank the following people for their many helpful suggestions and comments: Angela Ferrante, Irene Ip, Tom Kierans, David Laidler, John McCallum, Bill Robson, Daniel Schwanen, Peter Spiro, and Sylvain Venne.

1 As presented in Canada, *Shaping Canada's Future Together: Proposals* (Ottawa: Supply and Services Canada, 1991); and Canada, Parliament, Senate and House of Commons, Special Joint Committee on a Renewed Canada, *Report*, chaired by the Hon. Gérald A. Beaudoin and Dorothy Dobbie (Ottawa: Supply and Services Canada, 1992).

The term "efficiency" has a clear meaning in conventional economic theory, but it is far from clear that the process of development and wealth creation in Canada follows the conventional theoretical model. In fact, a new strain of thinking in economics poses a considerable challenge to the applicability of the conventional notion of efficiency and may have impaired it as a rationale for economic union.

This study examines the Canadian economic union and the notion of efficiency using the case of capital mobility. It addresses the following series of questions:

- What does "capital mobility" mean?
- Does capital appear to be mobile within the Canadian economic union? Does capital mobility promote economic integration in Canada? Is capital mobility efficient?
- Do we have barriers to capital mobility in Canada? If so, are they a cause for concern? Are we likely to have a problem with capital mobility in the future, especially if the Canadian federation is renewed in a more decentralized fashion?
- Should we entrench free mobility of capital in the Constitution? If so, should efficiency be the underlying rationale for the entrenchment?

Capital Mobility and Efficiency in Canada

This part of the study presents the efficiency argument for the four freedoms, offers a taxonomy of different types of capital mobility, and discusses Canada's historic experience with them. A comparison of capital movement within Canada and across a sample of sovereign states underscores the integrated nature of our economic union. By the end of this discussion, it will be clear that efficiency is not an appropriate underpinning for the entrenchment of protections for mobility.

Efficiency as a Rationale for Economic Union

In the abstract world of conventional economic theory, *efficiency* means obtaining the greatest value of goods and services output for given input services from land, labor, and capital. The way to achieve efficiency is to trade outputs and inputs on competitive markets where private property rights prevail and market forces have free rein.[2] Under these conditions, the prices of output goods and services signal producers as to what consumers want and the wages and rental rates for labor and capital input services signal the costs of alternative combinations of output goods and services. Firms compare the prices of output goods and wages and rentals for inputs, and decide what to produce and what combination of input services to use. The combined decisions of consumers, businesses, and workers lead to an efficient — highest-valued, least-cost mix — of output goods and services.

According to this theory, a key ingredient for efficiency is the free mobility of goods, services, people, and capital. As workers move from job to job and place to place, they can find their highest-valued occupations and make their strongest contribution to output. Firms can fully exploit economies of scale and gains to specialization. And they can plan for ever-larger markets when they know they have secure access from coast to coast. Barriers to the free flow of goods, services, people, and capital can only interfere with this achievement of the efficient level and mix of output goods and services. This is why many economists generally advocate economic union with legally supported guarantees of mobility.

This efficiency argument for the free mobility of goods, services, people and capital is compelling and forceful, but, like all theories, it is a drastic simplification of public policy reality. Although I support the entrenchment of the four freedoms, I argue for an

2 Along with the proposition that private market forces lead to efficient resource allocations, conventional economic theory offers a long list of caveats. For a discussion, see Robin Boadway, *The Constitutional Division of Powers: An Economic Perspective* (Ottawa: Economic Council of Canada, 1992).

alternative to efficiency as the underlying rationale. My argument for setting aside the efficiency underpinning has two steps:

- Many of the most important effects of capital mobility and market forces — particularly in long-term development, regional development (and decline), and the adoption of technology — do not correspond to the model of the efficient allocation of resources sketched above. I do not claim that these forces are inefficient. Rather, the theoretical notion of efficiency is static and does not describe well many important developments in the economy.

- The conventional economic notion of barriers to mobility casts too wide a net; strictly speaking, most public policies could be classed as barriers causing inefficiency. The ultimate effects of a four freedoms provision will be determined in courtrooms where interest groups collide. If the federal government's proposals are passed into law as written,[3] anyone who can make use of the strict theoretical notion of efficiency in order to advance his or her cause will do so if the word is available in the Constitution.[4] Moreover, judges and lawyers will be soon asking: What is efficiency? The possibility for miscommunication between the courts and expert witness economists is great when a concept such as efficiency is involved. Surely, if the rationale for a constitutional clause is too abstract and static to really guide jurisprudence, an alternative should be put in its place.[5]

3 The federal government does not now intend to enshrine the strict and pure notion of efficiency in the Constitution or to counter all possible barriers. The intentions of current officeholders, however, will not govern future use or interpretations of constitutional provisions.

4 The concerns many Canadians currently express about efficiency reveal, in part, the fear that this will happen. As a result, opposition to entrenchment of the four freedoms is higher than it otherwise would be.

5 The major alternative rationale for the provisions on economic union is founded on political rights of citizenship, a notion explored in Robert Howse, "Towards a High but Level Playing Field: Economic Union, Social Justice, and Constitutional...

Three Types of Capital Mobility

Starting with definitions can ease explanations and discussion. *Capital* means both *physical capital*, which is the plant, machinery, and equipment used in production, and *financial capital*, which is represented by a variety of certificates that prove either ownership of physical capital (such as stock certificates) or creditorship to owners of capital (such as bonds). Holders of these certificates have allowed their money to be used to purchase either physical capital or consumption goods. Accordingly, *capital mobility* refers to the transfer of purchasing power and movement of physical capital across distances as well as ready access to financial services that allow individuals and institutions to rearrange their portfolios of financial assets and liabilities.

A high degree of capital mobility is essential to an economy's wealth and development, but of the four economic freedoms, capital mobility is perhaps the hardest to understand. The movement of goods and of services from place to place is something most people relate to without difficulty, and labor mobility is almost as clear; after all, the vast majority of Canadians are involved directly as buyers and sellers in all three of these markets. Capital mobility is somewhat more difficult to comprehend as it involves impersonal financial flows in addition to highly visible investment decisions; a complicating factor in Canada is the federal government's huge and complex transfer system, which moves spending power from region to region within the federation.

Capital mobility can be made much easier to understand by breaking it down into three types:[6]

Note 5 - cont'd.

...Reform" (Paper prepared for the Centre for Public Law and Public Policy, Osgoode Law School, Toronto, 1992); and Daniel Schwanen, in this volume.

6 This classification system, like most, is not watertight; any given capital market transaction can probably be fitted into more than one of the three classes. Nevertheless, having this breakdown available will make the analysis of capital mobility much easier to carry out.

Migration mobility, which is closely related to labor mobility, reflects the fact that when people move from place to place a lot of capital (some of it their own) moves with them. Also, important shifts in the location of population cause some investments in infrastructure capital to lose value and at the same time create demand for new infrastructure investment (schools, public works, and so on) in new locations. Finally and perhaps most important, new centers of population growth provide the market and labor force that make further new investment worthwhile. This process attracts even more migration of people and further increases the incentive to invest in the new area. These "virtuous cycles" have become known as phenomena of *increasing returns* or *positive feedback effects*.

Balance of payments mobility refers to transfers of purchasing power via lending and direct investment from regions with high savings and/or low investment opportunities to regions with low savings and/or high investment opportunities. The transfer of purchasing power enables the recipient region to invest at a rate in excess of its own generation of savings.

Transfers of this sort are brought about by current account surpluses in regions that are net providers of savings and current account deficits in regions that are net users of savings. Indeed, as explained later, this type of capital mobility can be measured by the behavior of a nation's or province's current account balance — hence the phrase "balance of payments mobility."

Balance of payments mobility is much less likely than migration mobility to be connected to movements of people. It is, however, the most important type of capital mobility across the boundaries of sovereign states, where borrowing and lending can occur but labor mobility is heavily restricted by immigration laws. The recent experience of the German economy provides a good example of balance of payments capital mobility. Between 1960 and 1991, the Federal Republic of Germany was, on average, a net supplier of funds to the rest of the world. Since German reunification in 1991, the German economy has been faced with the burden of rebuilding eastern

Germany. One result has been the dwindling of the country's current account surplus; the German economy no longer has extra savings to lend abroad.

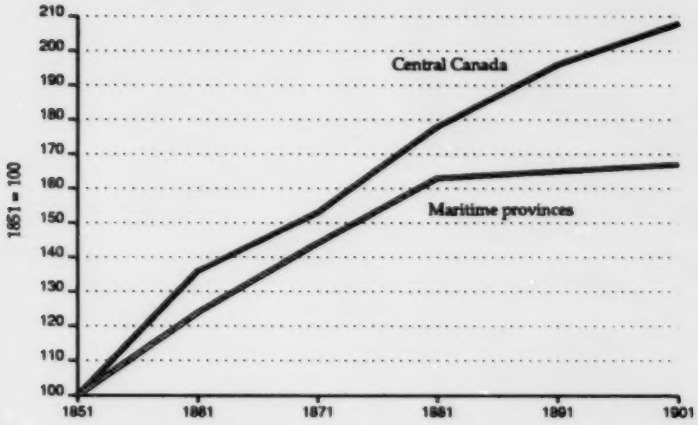
Diversification mobility concerns the ease with which an individual or institution can rearrange a portfolio of financial assets and liabilities in order to achieve preferred degrees of risk and diversification. Thus, this third kind of capital mobility does not necessarily involve transfers of funds or migrations of people and capital from region to region. It is, however, extremely important to advanced economies such as that of Canada. It is fostered by the development of an advanced and sophisticated financial services industry.

Migration Mobility and Canadian Economic Development

The migration of people and capital into Canada from abroad and within Canada from region to region has been a key feature of the country's economic development. It has allowed valuable "agglomerations" or concentrations of economic activity to form in our major urban centers and permitted the West to be settled and developed. But the same forces have also left some regions behind, at times contributing population and capital to other regions rather than receiving them. The Atlantic provinces, Manitoba, and Saskatchewan have not been as prosperous as other provinces, which have experienced more stable growth.

Canada's economic structure has been called a "center-periphery" structure on account of the concentration of manufacturing in Central Canada with the production of staples and resource extraction dominating in the rest of the country. Of the many reasons for this pattern of development, the most powerful include shifting comparative advantages, government policies such as the tariff (which favored Central Canada), rail policy (which facilitated the settlement of the West), and forces of positive feedback or agglomeration, which again favored Central Canada.

Figure 1: ***Population Indices, Maritime Provinces and Central Canada, 1851–1901***



Source: Census of Canada.

Conventional economic theory holds that labor and capital respond to market forces, moving to the locations and occupations in which they have the highest value, thereby generating efficient or optimal outcomes. There is no question that market forces move resources to higher-valued uses and that this process generates wealth. But whether it can usefully be described as efficient or optimal is doubtful, especially in the context of long-term industrial development and migration.

An example can help to clarify the point. Figure 1 shows the populations of the Maritimes and Central Canada, both indexed to equal 100 in 1851, the first year for which population data are available. Until the early 1880s, the Maritimes kept pace with Central Canada and enjoyed a prosperous economy based on timber, the fishery and shipbuilding, and its spinoff, shipping services. In the 1880s, however, the region entered a period of population stagnation and poor economic performance.

What happened? Jane Jacobs has suggested one cause in a comparison of the wooden shipbuilding industries in Nova Scotia and Norway, which competed with one another a century and a half

ago.[7] Both economies used their place in this industry to enter the shipping business and thus earned foreign exchange via the export of shipping services. In the 1870s, however, wooden sailing ships began to be replaced by steel steamships. Norway quickly made the conversion to manufacture of steel ships, whereas Nova Scotia did not, despite the local availability of coal and iron. The collapse of the timber and shipbuilding industry in Nova Scotia ushered in an era of population stagnation and economic retardation from which the Atlantic Canadian economy never fully recovered. Had Nova Scotian business people taken different business decisions in the 1870s and 1880s, the region might have been set upon a more prosperous course.

Is it reasonable to suggest that Nova Scotia had a comparative advantage in building wooden ships but not steel ships? If so, the demise of its shipbuilding industry would have been an efficient response to a change in technology. But this explanation will not work. Nova Scotia had the same natural advantages as Norway and hence the same opportunity to create a comparative advantage in the new industry.

The story of the nineteenth-century Maritimes reveals that economic development processes frequently reflect not efficient resource allocations but rather historical accidents leading to strong feedback effects. Nova Scotia's failure to adapt to new technology led to a contraction in the shipbuilding and shipping services industries. As a result, much skilled labor and capital resources left the region, making it an even less attractive location for investment, and so on.

This process of cumulative adjustment to innovation was described as early as 1928 by Allyn Young, one of the first proponents of the importance of increasing returns and positive feedbacks in economics:

> Every important advance in the organization of production, regardless of whether it is based on upon anything which in a narrow or technical sense, would be called a new "invention,"

7 Jane Jacobs, *The Question of Separation: Quebec and the Struggle over Sovereignty* (New York: Random House, 1980), pp. 57–60.

> or involves a fresh application of the fruits of scientific progress to industry, alters the conditions of industrial activity and initiates responses elsewhere in the industrial structure which in turn have a further unsettling effect. Thus change becomes progressive and propagates itself in a cumulative way.[8]

Conventional and Increasing Returns Economics Contrasted

The contrast between the conventional and increasing- returns views of the operation of market forces is striking. Consider the following:

Tom Courchene provides a clear statement of the conventional view of regional adjustment and resource mobility.[9] Suppose wages are higher in Region A than they are in Region B. Labor then migrates to A to take advantage of the higher wages, while capital flows in the opposite direction to profit from the cheaper labor supply. As labor moves from B to A, where wages are higher, the wage differential between the two regions falls. As capital moves from A, where labor costs more, to B, the return to capital in the two regions is equalized. Thus, disparities between the two regions are reduced. Moreover, production increases because the reallocated resources have higher productivity; economic efficiency is increased as a higher output is derived from the same quantity of labor and capital. The pie is larger, and its regional sharing more equal. All is well.

Now let us introduce some positive feedback elements into the same story.[10] It is not necessarily true that labor migrates in one direction and capital in another; they both may end up moving in the same direction.

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8 Allyn Young, "Increasing Returns and Economic Progress," *The Economic Journal* 38 (December 1928): 527–542, 533.

9 Thomas J. Courchene, "Avenues of Adjustment: The Transfer System and Regional Disparities," in Michael Walker, ed., *Canadian Confederation at the Crossroads* (Vancouver: Fraser Institute, 1978), pp. 143–186.

10 The following discussion borrows heavily from Mario Polèse, "Regional Disparity, Migration, and Economic Adjustment: A Reappraisal," *Canadian Public Policy* 7 (Autumn 1981): 519–525.

Start by considering some implications of the flow of labor from Region B to Region A. Migrants stimulate a demand for public infrastructure, adding to A's existing demand for labor. Moreover, the newcomers generate consumer demand, again stimulating A's demand for labor. They import their savings and perhaps physical capital as well. Thus, the initial supply of new labor to the region exerts a positive feedback effect on the demand for labor in the region, which, in turn, stimulates further migration into the region. Meanwhile, the initial drop in employment in region B works in a parallel but opposite direction. As people leave B, the demand for public infrastructure falls, reducing the demand for labor and causing employment in that region to fall even further.

The migration also has agglomeration effects. As more people and capital concentrate in Region A, they attract even more migrants. The agglomerating region becomes the best place to hire workers and thus to set up new businesses; it also becomes the best place to sell products and specialized services, as there are more and more buyers close at hand. Meanwhile, the other region experiences these effects in reverse. If the unraveling process in Region B is severe enough, its economy stagnates and may even atrophy.

Research by Mario Polèse in 1981 suggests that these migration multiplier effects can be quite significant.[11] They may even increase regional disparities. Certainly, the positive feedback effects in this model are quite different from the negative feedback effects of the traditional model, in which capital and labor move in opposite directions, bringing a disequilibrium to a close. As Brian Arthur, a leading researcher in increasing-returns economics puts it:

> Conventional economic theory is built on the assumption of diminishing returns. Economic actions engender a negative feedback that leads to a predictable equilibrium for prices and market shares. Such feedback tends to stabilize the economy because any major changes will be offset by the very reactions they generate....

11 Ibid.

> Such an agreeable picture often does violence to reality. In many parts of the economy, stabilizing forces appear not to operate. Instead positive feedback magnifies the effects of small economic shifts; the economic models that describe such effects differ vastly from the conventional ones.[12]

Summary

The purpose of the previous discussion is not to show that market forces or agglomerations of economic activity are bad. On the contrary, the forces present in a market-driven economy are crucial to economic wealth and welfare, and concentrated clusters of economic activity are extremely valuable national assets. However, the particular pattern that market forces and development follow in a national economy, with some regions growing rapidly while others stagnate or decline, may be miscast as an "inevitable" and "efficient" process. Instead, what occurs is an ongoing sequence in which chance events, government policies, and shifts in the terms of trade all interact to produce outcomes.[13]

In Canada, government policies are frequently cited as having had an enormous impact on the creation of the center-periphery economic structure. The conventional notion of economic efficiency as expressed in the story of adjustment between Region A and Region B tends to view any outside influences on migration as distortions that cause an inefficient reduction in output. The reality may be a never-ending series of distortions.

Robert L. Mansell provides a good summary of these points. After stating the hypothesis that Canadian economic policies have been location-neutral and optimal from a national efficiency viewpoint," he critiques it:

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12 W. Brian Arthur, "Positive Feedbacks in the Economy," *Scientific American*, February 1990, p. 92.

13 Appendix A expands on the topic of non-efficient results of market forces when increasing returns are present. Focusing on the modern situation, it surveys some ideas involving high-tech competition, learning by doing, and industrial location.

> Clearly, acceptance of this hypothesis implies that provincial policies aimed at changing the province's economic base result in a national welfare loss, and, therefore, should be discouraged unless equity considerations dominate. However, there are a number of reasons to question its validity. First, even if it can be demonstrated that policies such as those involving transportation rates and tariffs are, on balance, location-neutral, there are other less visible policies and institutional arrangements which are definitely non-neutral in this sense....
>
> Second, the argument that the operation of market forces, unhindered by non-neutral government policies, results in an "optimal" regional distribution of industry and population assumes, among other things, "perfect information" and the absence of externalities and indivisibilities. However...it is unreasonable to assume that all opportunities and all entrepreneurs confront each other; hence, locational decisions are often based on "satisficing" rather than "maximizing" criteria. Also, since the profitability calculations of firms do not normally include social costs in the form of pollution or congestion, or the costs of most economic or social overhead capital (such as roads or education), there is no assurance that the resulting location decisions will lead to a social optimum....
>
> In fact, when account is taken of the net locational effects of all provincial and federal policies, institutional arrangements and the above types of "market failures", a western shift such as that associated with Alberta diversification policies may be consistent with both provincial and national efficiency. Of course, the major problem which still remains is to develop the specific criteria which must be applied in the evaluation of provincial government interventionist policies in order to protect against the spectre of a regional industrial system becoming a ward of the state.[14]

The point is that if the notion of efficiency accompanies constitutional protections for the economic union, future legal interpreta-

14 Robert L. Mansell, "Comments on the McMillan/Norrie and Drugge/Veeman Papers, *Canadian Public Policy* 6 (supplement, February 1980): 231–233; reprinted with permission. For an important statement of the problem of increasing returns, agglomeration tendencies, and regional disparities, see also Nicholas Kaldor, "The Case for Regional Policies," *Scottish Journal of Political Economy*, November 1970, pp. 337–348.

tions may confuse the conventional economic model and the public policy reality. Therefore, if we decide to entrench such protections in the Constitution, the notion of efficiency should be set aside in favor other supporting rationales for economic union.[15]

Balance of Payments Mobility and the Canadian Economic Union

The second type of capital mobility, balance of payments mobility, allows nations or regions with excess saving to transfer their unused purchasing power to other nations or regions with excess investment opportunities. After analyzing how the mechanism works and critiquing the traditional assumption that capital is perfectly mobile across national borders (in the absence of deliberate distortions), I will compare the degree of balance of payments mobility within the Canadian economic union to that of a sample of 22 members of the Organisation for Economic Co-operation and Development (OECD). The results are consistent with the notion that capital flows more freely within an economic union such as Canada's than it does across sovereign states.

Some Definitions

The analysis of balance of payments mobility involves the use of national income accounting concepts, which some people find a little difficult to follow. The key point to understand is that a nation's or region's net export of capital to the rest of the world is the difference between its flow of saving and its flow of investment. This difference is also equal to its current account surplus in its balance of payments. Similarly, a nation or region that is a net importer of capital has a flow of investment greater than its flow of saving, and it has a current account deficit in its balance of payments.

15 Indeed, the fact that the federal proposals for economic union provisions, as well as the Beaudoin-Dobbie Report, contain exemptions for programs aimed at regional development can be viewed as implicit recognition that efficiency cannot stand alone as an underpinning for economic union protections.

For readers unfamiliar with this terminology, here are some definitions and explanations.

Saving is that part of income, revenue, or profit that is not spent on consumption. Thus, a decision to save is a decision to refrain from spending on consumption. An *investment*, in contrast, is a decision to spend on a particular type of commodity: physical capital.

Although saving or investment decisions can be made at a point in time, they are measured over a span of time, such as a month, quarter, or year. Because they have a time dimension, they are called *flows*. In contrast, a *stock*, such as the capital stock or the accumulation of the flow of saving, is measured at a point in time and thus has no time dimension. An analogy can make this point very clear. A bathtub holds a stock of water, which gets larger if the flow of water in from the tap (gross investment) exceeds the flow of water out through the drain (depreciation). The net flow of water corresponds to net investment.

A *capital flow* is a transfer of purchasing power from a person, region, or nation that has made a saving decision to another person, region, or nation that has made a spending decision. In exchange for the transfer of purchasing power, the saver receives evidence of the borrower's indebtedness (in the form of a bank account, cash, or a bond for example) or ownership (in the form of a stock certificate for equity investment). The extra spending allowed by the capital inflow causes a net movement of goods from the saver region to the spending region.

The major categories of capital flows are loans, purchases of portfolio investments, such as stocks and bonds, and direct investment (setting up a new business or buying out an existing one in the spending region).

The *gross capital flow* from one region to another is the total of all new loans, portfolio investments, and direct investments going from one to the other. The *net capital flow* between two regions is the difference between the gross amount going from one region to another and the gross amount going in the opposite direction.[16]

16 Notice that the net-gross capital flow distinction is similar to but a little different from the net-gross investment distinction. To calculate net investment, one subtracts wear and tear (depreciation) from gross investment within one region....

Are net flows of capital a truer measure of capital mobility than gross flows? Two regions can have large but roughly offsetting gross flows of capital going between them; the net flow is negligible, but this would be evidence of some degree of capital mobility. Offsetting gross flows of capital between two regions cannot, however, bring about a net transfer of physical capital from region to region. If one region has many more unexploited investment opportunities than another, an incentive exists to move saving from the latter to the former. But this goal can be accomplished only with a net capital flow. Thus, observing the behavior of net capital flows between nations (or provinces) is important for understanding how well physical capital moves from place to place in search of the best investment opportunities.

Capital Mobility across Borders

It has become a commonplace that capital is highly mobile internationally. "Hot money" flows rapidly from one major financial center to another around the world. The interbank foreign exchange market never closes. Nevertheless, a large number of recent studies have questioned how mobile capital really is internationally.[17] The reason is a robust empirical finding that national saving rates and national investment rates tend to be closely related. In other words, nations that have high saving rates tend to have high investment rates, while nations that save little tend to invest little. Therefore, the net flows of capital between nations do not appear to be as large as would be expected in light of the great variation in investment opportunities around the world.

Note 16 - cont'd.

...To calculate net capital flow, one subtracts the movements between two regions. Indeed, one can calculate net capital flow with either gross saving and investment or net saving and investment:

Gross saving – gross investment = net capital outflow.
Net saving – net investment = net capital outflow.

17 Perhaps the earliest paper in this literature is Martin Feldstein and Charles Horioka, "Domestic Saving and International Capital Flows," *Economic Journal* 90 (June 1980): 314–329.

Let us follow this logic in more detail. For an economist, a high or near-perfect degree of international capital mobility is characterized by the following conditions:

- the rates of return on physical as well as financial capital approach equality between countries;
- the mechanism that brings about this equality is the net flow of saving from one country to another via current account imbalances.

Thus, if capital mobility is high, one nation's saving rate is not likely to be equal to its investment rate. When it wants to increase its investment rate, it is not limited to domestic saving; it can easily obtain the money in the international capital market. But if capital does not move well from nation to nation, one nation's saving rate is much more likely to be equal to its investment rate. This equality or lack of equality between saving and investment should hold true for both year-to-year changes and long-term averages.

Consider the following example. Suppose the world consists of Region A and Region B, each of which produces a consumption good and a physical capital good. Initially, their respective current accounts equal zero, and neither is in debt to the other. Then B experiences a large increase in its investment opportunities; consequently, the demand for the capital good goes up there. In other words, the rate of return on investment in Region B increases relative to that in Region A.

What happens next depends on the degree of capital mobility between the two regions. If their economies are closely integrated — say, because they are bound together in an economic union and use the same currency — B can import capital from A and raise its rate of investment without cutting consumption. Region B purchases more of the capital good from Region A and thus incurs a merchandise trade deficit with Region A as Region B's imports from A go up. At the same time, B begins to owe money to A.

Now suppose the two economies are not closely integrated. Cultural, legal, and/or institutional differences may make it difficult

to move capital from one region to the other. Or perhaps the two regions use different currencies.[18] At any rate, when Region B's demand for capital goes up, it cannot easily import more capital from Region A. Rather, it must reduce consumption and correspondingly increase saving in order to allow for the extra investment to take place. In this case, B does not go into debt with A.

Which case seems to occur in the real world? As already mentioned, many academic studies have found a close relation between national savings rates and national investment rates. Although all the authors do not agree on how to interpret these results, it is fair to say that the preponderance of opinion is that they show that the assumption of perfect capital mobility does not hold internationally.

This hypothesis can be strengthened if one can show that the expected result of high capital mobility — a *lack* of relationship between saving and investment rates — does not exist in a well-integrated economic union, one where goods, services, people, and capital face relatively few barriers to movement and institutions are similar from coast to coast. The Canadian economic union seems likely to present such a case. Thus, our next objective is to put this hypothesis to the test by comparing saving and investment data from a sample of sovereign OECD countries with Canadian interprovincial data.[19]

The Data: Saving and Investment in OECD Countries

For the information on sovereign countries, it is convenient to use data from 22 OECD countries averaged over the time period from 1960 to 1987. Table B-1 presents their ratios of saving and of investment to GDP. Figure B-1 shows a scatter plot of the same information; it reveals a tight correlation between national saving rates and national investment rates when averaged over this long period of time.

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18 Currency union is generally thought to be one of the most important aspects of economic union.

19 For convenience, the tables and charts for both sets of data are gathered into Appendix B.

This pattern casts considerable doubt on the presence of perfect international capital mobility. If capital were perfectly mobile, an extra dollar of saving in one country would be added to the world pool of saving flows and would finance investment or consumption somewhere around the world, wherever the reward for doing so was the greatest. There would be little reason to expect to observe a close relationship between saving and investment rates.

In fact, the OECD nations are a widely dispersed group, exhibiting considerable differences in economic structure, government policies, culture, and investment climate. None of them shares a common currency.

The Data: Saving and Investment across Canada's Provinces

Balances of payments data for nations are generally available, which may be why they have been studied extensively. Balance of payments data for subnational units are much harder to come by; they are simply not recorded *per se* by the usual statistics-keeping agencies. For Canada, however, the current account balances of the provinces can be estimated from the *Provincial Economic Accounts*.[20]

Using these estimated data, one can construct a scatter plot of saving and investment ratios to GDP for Canada's ten provinces averaged over the years from 1961 to 1989 (see Figure B-2), a period closely matching the period just examined for the OECD countries. The close correlation between saving and investment rates exhibited by OECD nations is absent for the Canadian provinces;[21] the scatter looks very random. This finding is consistent with a high degree of capital mobility: an extra dollar of saving in one jurisdiction flows

20 Appendix C explains the methods used for these calculations and develops accounting identities to provide conceptual support.

21 The contrast between the OECD data in Figure B-1 and the Canadian provincial data in Figure B-2 cannot be entirely attributed to differences in capital mobility. The size of the jurisdiction is also a factor in the size of the saving-investment gap. Large countries tend to be diverse and so may have regional saving and investment differences that cancel out for the nation as a whole. Thus, such countries may have less need to borrow and lend in international capital markets...

into a larger pool of saving and finances investment and consumption in several different jurisdictions.

This result is perhaps not surprising: the provinces are joined in an economic union in which there is a high degree of resource mobility and a fair degree of harmony in government policies from coast to coast. Moreover, Canada has a currency union as well as nationwide financial institutions that can absorb saving in one province and turn it into credit to finance investment and consumption in another province. Finally, the federal government is heavily involved in transferring funds from region to region within the union.

Tables B-2 and B-3 allow a closer look at the data, permitting examination of the federal government's role in interregional transfers. These tables show two subperiods, 1961 to 1974 and 1975 to 1989, which are examined because some aspects of Canada's saving behavior changed substantially between them.

Table B-2 includes the federal government's dissaving and investment spending, while Table B-3 excludes the federal balance by region. The federal balance in a province is the difference between the federal taxes raised there and the federal spending that goes into it. If the federal government spends more than it raises in a province, it is a dissaver (its balance is negative) for that province. If, in contrast, the federal government taxes more than it spends in a particular province, it is a saver for that province.[22]

Canada's almost perennial current account deficit is reflected in the gap of 1.7 percentage points between the average saving and average investment ratio over the 1961–89 period. As shown in Table B-2, this gap was even greater in the earlier subperiod. During the later one, both saving and investment were lower, but investment fell more than saving, resulting in a smaller imbalance.

Note 21 - cont'd.

...than would smaller jurisdictions. Some of the OECD countries in the sample are certainly large enough to experience this phenomenon. One can, however, roughly offset it by examining only those with a population equal to or smaller than Ontario's (nine OECD countries in total). The relation between saving and investment is still very close.

22 Appendix C discusses federal balances in more detail.

Excluding federal government balances from the data (Table B-3) reveals a tendency for provincial saving to increase strongly in the 1975–89 period over the 1961–74 period. This result is, in part, a reflection of a rise in federal government dissaving in the latter period. By providing higher incomes via debt-financed government purchases, transfers, interest payments, and so on, the federal government created more opportunity for saving by other sectors — in particular, the provincial governments.

The provincial investment data generally show the same tendency with or without the federal balances: to be moderately lower in the more recent subperiod. It is interesting to note, however, that when the federal balances are removed, the saving decisions in the provincial economies moved in a direction opposite to the trend in investment rates. Although provincial saving was undoubtably aided by federal dissaving, as already noted, this pattern is consistent with a well-functioning economic union, which succeeds in the spatial transfer of purchasing power.

When the data are examined by region, the Atlantic provinces show large imbalances with or without the federal balances. Without them, the imbalances are smaller, reflecting the role of federal transfers in the Atlantic economy. Even these smaller imbalances appear large. They are, however, smaller in the second subperiod than in the first, in part, reflecting an adjustment to the earlier period's excessive buildup of government debt.

A comparison of Tables B-2 and B-3 also emphasizes the redistributive nature of federal government balances. When these balances are removed (Table B-3), the difference between the saving ratio and the investment ratio goes down for each "have" province (British Columbia, Alberta, and Ontario) but rises for each "have-not" province. The phenomenon reflects the fact that the federal transfer system moves funds from the "have" provinces to the "have-not" provinces.[23]

23 For several papers dealing extensively with the magnitude and importance of federal transfers in Canada, see Norman Cameron et al., *From East and West: Regional Perspectives on Reconfederation*, The Canada Round 6 (Toronto: C.D. Howe Institute, 1991).

One can also say that removing the federal balances provides the more accurate impression of the net inflow of "foreign" capital — that is, capital from the federal government, the other provinces, and the rest of the world — into the deficit provinces. Federal balances do not give rise to a provincial obligation to pay back and thus create no debt-service burden.[24]

The Data: Canada and the Provinces across Time

In addition to looking at long-term averages of the ratios of saving and investment to GDP, one can also examine year-to-year variations in these ratios.

Figure B-3 shows a time plot of the national saving and investment rates from 1961 to 1989. A high degree of correlation, or co-movement, between the two is evident. Contrary to what would be expected in a world of perfect capital mobility, increases or decreases in the national saving rate are closely matched by increases or decreases in the national investment rate. An extra dollar of saving, rather than flowing into a world pool of funds that finances investment and consumption in many countries, appears as though it is invested in the domestic economy.

The most obvious exception to the overall pattern is in the movements of the two rates from 1984 to 1986. The national saving rate plunged, while the investment rate continued to rise. Afterward, both rates moved in a parallel fashion again, although the gap between them remained wide.

Figures B-4 through B-10 display similar time series for the provinces.[25]

Alberta is an interesting case with which to begin. Figure B-4 reveals that, from 1961 to 1973, its investment ratio outstripped its

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24 Under this view, federal balances are treated as unilateral transfers, which are a current account item, as opposed to a capital account item, in conventional balance of payments accounting.

25 All the time series data here omit the federal balances.

saving ratio by a considerable margin and with little co-movement. In the early 1970s, Alberta's saving rate rose rapidly as the province enjoyed higher economic rents from oil production. Investment, however, apparently did not respond vigorously to the oil patch opportunities until 1975. From that year, both saving and investment jumped until the early 1980s and the end of the oil boom. The lag in investment reflected the fact that income from oil revenues began to flow into saving immediately with the oil price increases. Oil exploration investments, however, took time to get under way. Then, as migrants began to flow into the province, in search of new opportunities, the demand for public infrastructure grew. The supply responded to the demand with the usual lag, and construction of hospitals, courthouses, high schools, roads and so on got under way.

From 1970 to 1980, the Alberta saving rate almost doubled, going from 22 percent to 37 percent, while the investment rate rose less spectacularly from about 29 percent to 35 percent. The mid-1980s saw dramatic and disparate gyrations in the saving and investment rates.

These interesting patterns are consistent with a high degree of capital mobility at the provincial level in Canada. Alberta's early position as a net borrower changed dramatically in response to the swings in resource prices. During the oil-boom decade, Alberta had a rough balance between saving and investment; afterward, its saving exceeded its investment. Thus, Alberta became a net lender to the rest of the world.

Saskatchewan also benefited from the 1970s increase in oil prices but not nearly as much as Alberta did. Figure B-5 shows the saving and the investment rates were at roughly similar levels but with a fairly low correlation. Until 1970, investment was generally larger than saving, but in the early 1970s saving increased considerably while investment lagged behind — a pattern somewhat similar to Alberta's. After 1975, saving and investment became much closer in magnitude but without much co-movement.

Ontario's chart (Figure B-6) reveals that, over the 1961–74 period, the saving and investment ratios in the province seemed to

move as closely together as they did for the national economy over the whole period. After 1974, however, the pattern was broken completely as the saving rate rose while the investment rate plummeted. The behavior of the investment rate is not hard to understand. Ontario, an oil-importing province, was buffeted by the rise in oil prices and the recession of 1974–75. The deep recession of 1982–83 was clearly reflected in the sharp drop in investment at that time. The gap in Ontario's saving and investment balance ratios during the 1975–89 period is truly amazing. As reported in Table B-3, the average difference was 1.1 percentage points from 1961 to 1974 but 6.0 percentage points thereafter.

British Columbia's chart (Figure B-7) reveals a pattern almost exactly opposite to Ontario's. Until 1975, British Columbia's investment rate far outstripped its saving rate and the two displayed little correlation. Afterward, the two rates became much more similar in magnitude and exhibited a much closer degree of correlation.

Manitoba's chart (Figure B-8) is less dramatic than the previous two. Aside from a steep drop in the investment ratio in the late 1970s and early 1980s, the two rates were close in size and displayed a fair degree of correlation.

Quebec's investment ratio showed considerably more volatility than did its saving ratio (Figure B-9). The province's financial system has some features, such as the Caisse de dépôt et placement du Québec and the Mouvement Caisse Desjardins, that distinguish it from the system elsewhere in the country. Yet there is no evidence here that the province's distinctive financial institutions and policies noticeably segment its capital market from the rest of Canada's. Indeed, Figure B-9 reveals considerable fluctuation in the balance of Quebec's saving and investment ratios, indicating a high mobility of capital into and out of the provincial economy.

The Atlantic provinces' data were aggregated into a regional total for Figure B-10. The region had a very high rate of overall investment until the mid-1970s. Thereafter, it drifted down, though it remained high. The saving ratio during the first part of the period was much lower than the investment ratio. In 1971, however, the saving ratio

began to increase substantially, and by the late 1970s, the gap between investment and saving was not so large. The increase in the saving ratio beginning in 1971 came mainly from increases in personal saving and may reflect higher personal income resulting from the liberalization of unemployment insurance program benefits that occurred in that year.

Canadian Capital Mobility and Investment Composition

A comparison of the composition of Canada's international financing with its internal patterns of borrowing and lending sheds some light on why capital is more mobile within the union than between Canada and other countries. Table 1 presents some summary information on Canada's international investment position with the rest of the world and with the United States alone — because the United States is clearly the country with whose capital markets Canada's are most closely integrated — plus data on domestic investment.

Of Canada's 1990 total gross foreign liabilities, $209.3 billion — 46 percent — was to the United States. And of that amount, a total of –$152.2 billion — 72.7 percent — was in the form of direct investment, bonds, and stocks. These instruments exhibit a considerable range of liquidity, but not a great range in intermediation. In other words, the bulk of U.S. investment in Canada reflects direct ownership or direct contractual obligations between the borrower and lender.

The typical patterns of asset holdings within Canada are quite different. As shown in the bottom part of Table 1, in 1989 the Canadian household and unincorporated business sector[26] held $1,102.8 billion in gross financial assets. Of this amount, 61.3 percent was invested in accounts with banks and near banks and in life insurance and pensions. These forms of asset holding are characterized by heavy intermediation through a nationwide financial system. In other words, the funds that flow into such investments from

26 This sector was the only one aside from social security funds that was a net financial creditor in the national balance sheet accounting framework.

Table 1: *Canadian Investment, External and Internal*

	$ billions	Percent
International investment, year-end 1990		
With all countries		
Gross foreign assets	197.2	
Gross foreign liabilities	456.3	
Net position	*–259.1*	
With the United States only		
Gross foreign assets	101.9	
Gross foreign liabilities	209.3	100.0
Direct investment	79.1	37.8
Bonds	54.4	26.0
Stocks	18.2	8.7
Total	151.7	72.5
Net position	*–107.4*	
Domestic investment (households and unincorporated businesses), year-end 1989		
Gross financial assets	1,102.8	100.0
Life insurance and pensions	294.1	26.7
Currency and bank accounts	201.6	18.3
Deposits in other institutions	179.5	16.3
Total	*675.2*	*61.2*

Sources: Statistics Canada, *System of National Accounts, Canada's International Investment Position*, Cat. no. 67-202; and idem, *National Balance Sheet Accounts*.

individual Canadians are managed by large institutions that stand between the saver and the ultimate borrower. The institutions in the middle have a nationwide reach. Their intermediation transforms and repackages the funds they receive from individual Canadians into forms of credit that are desirable for the borrowers at the end of the line.

The difference in asset-holding behavior across separate countries on the one hand and within a country such as Canada on the

other illustrates the potential for greater capital mobility within an economic union that has nationwide, integrated financial services and a currency union.

Diversification Mobility

A well-developed financial services industry is also essential for the final type of capital mobility: diversification mobility.

"Diversification" means spreading risk among a variety of different financial assets. In other words, it is the alternative to putting all your eggs in one basket. In an earlier era, achieving a well-diversified portfolio was a costly, if not impossible, undertaking for an average Canadian with only his or her personal savings to invest. The fees brokers charged to process orders for small quantities of stocks and bonds would quickly eat into the gains to be had by holding a widely diversified portfolio. Today, the picture is entirely different. All varieties of stocks and bonds can be purchased with minimal transactions fees via discount brokers. Canadians can invest in prediversified mutual funds that package a vast array of investment vehicles from money market instruments to "ethical growth funds." Highly sophisticated contracts, such as options and futures, are also readily available. Whereas the limiting factor on small investors' choices was once transactions costs, it is now effectively their own knowledge and understanding of the products available.

Financial services have been revolutionized throughout the developed world. Canada has been particularly well placed to benefit from this change, in part because of the country's relatively wise government regulation of financial services and in part because of its fully integrated nationwide banking system, which allows maximum advantages from economies of scale, and geographic and sectoral diversification. With state-of-the-art financial services, the small Canadian investor can play the yield curve, take a position on the Canadian dollar, and manage proportionate investments in cash and fixed-income and equity instruments, all within a tax-deductible registered retirement savings plan.

Summary

Capital mobility has made a great contribution to the wealth and welfare of Canada and the functioning of the economic union. It has helped the process of industrial development and allowed regions with excess saving to invest in those with insufficient saving relative to their investment opportunities.

Perhaps not surprisingly, the data discussed in this section show that there is a higher degree of capital mobility within Canada than there is in a large sample of OECD countries. The reasons are not hard to find. Canada is an economic union with a nationwide banking system and currency union. Its system of national financial service institutions is regarded as one of the best in the world; it is characterized by private enterprise, rather than state ownership, and a history of government regulation that is relatively benign — especially in comparison to that of our neighbor to the south.

Although capital mobility is alive and well within the Canadian economic union, this section has cast doubts on the accuracy and desirability of describing that mobility as "efficient" in the strict theoretical meaning of the word. The location of investment in Canada reflects a mix of factors, such as government policy, cumulative causation, and comparative advantage. These forces are not by nature inefficient, but the concept of efficiency is not easily applied to long-term processes of development and industrialization. For this reason, if Canadians opt to entrench a strengthened economic union, the clause or clauses should avoid the word "efficiency," as its rigorous meaning could lead to mistakes in application of the law.

Barriers to Capital Mobility

The conclusion that capital is highly mobile within the Canadian economic union and between Canada and its largest trading partner, the United States, is not a proof of an absence of barriers to the mobility of capital. Moreover, it does not allow Canadians to set

aside concerns over capital mobility when they debate constitutional protections for the economic union. Even if they conclude that no important barriers to the movement of capital exist currently or are ever likely to exist even in a renewed, more decentralized federation, they must consider the ramifications for the other three freedoms of a failure to entrench free mobility of capital. Thus, this section examines the general nature of barriers to capital mobility and then looks at several provincial public policies that have been construed to be barriers.

Barriers to Capital and the Taxonomy of Barriers

The current round of constitutional debate has clarified understanding of the types of barriers that may hinder an economic union. Daniel Schwanen examines a variety of barriers to the free movement of goods, services, people, and capital and sets up a threefold taxonomy: type I, which discriminate in favor of local industry; type II, which are regulatory or administrative practices that, although not explicitly discriminatory, manage to achieve the same protectionist effect; and type III, which are government subsidies that are not concrete obstacles to trade but tend to influence or lure the location of production into the home jurisdiction.[27]

All three types affect capital flows by altering business production and location decisions from what they would otherwise have been. The first two types, however, are primarily associated with the movement of goods, services, and people; their effect on capital mobility arises only incidentally to their primary effects, so discussion of them is not pursued here. In contrast, most subsidies have their immediate effect via a lure to capital or an aid that keeps capital in a certain employment, and from this flows their effects on trade in goods and services.

27 Schwanen, in this volume.

Subsidies and Capital Mobility

Schwanen suggests that, once a type III barrier has been identified, any remedies should be contingent on an injury test followed by a vote by federal and provincial executives. Even if a subsidy offered by, say, a provincial government was shown to have injured industries in other provinces, that government would be able to continue the program if it could win enough support from other provinces.

Let us examine a few high-profile public policies that have frequently been the focus of controversy over capital mobility in Canada. Could they be challenged as type III barriers, significantly affecting capital mobility in Canada?

The Quebec Stock Savings Plan

The government of Quebec has expressed considerable concern about small business access to financing via equity capital. This concern has led to a variety of programs that act on both the supply side and the demand side for equity shares for firms located in Quebec. The most prominent of these programs is the Quebec Stock Savings Plan (QSSP). Started in 1979, the program awards tax deductions for the purchase of shares of qualifying firms.[28] Thus, it increases the amount of private sector saving in the form of share ownership in Quebec and targets that increase into the share capital of eligible Quebec firms. Other stated rationales for the program include a desire to increase share ownership of Quebec firms by Quebecers — thereby increasing their investment sophistication and involvement in the economy — and to reduce the tax burden of high-income Quebecers who are willing to make equity investments.

A perennial problem with policies such as the QSSP is targeting firms that really do have trouble raising equity capital without

28 QSSP deductions are allowed on top of Registered Retirement Savings Plan (RRSP) deductions and thus provide an incentive to save over and above that provided by RRSPs. Moreover, money invested in a QSSP can be withdrawn with no tax liability if the shares sold out of the plan have been held for three years; thus the QSSP does not merely defer taxes, as does an RRSP.

subsidizing well-established firms that have good access to capital markets. Several modifications have been made over the plan's life to attempt to improve targeting.

Is the QSSP a barrier to the mobility of capital? If so, would it be challengeable under the economic union protections advocated by Schwanen? Since the QSSP provides a tax benefit for share ownership, it can be viewed as subsidizing the access of some firms to equity financing. The subsidy has the effect of raising the flow of private saving held in equities in the Quebec economy and of simultaneously increasing investment by the targeted firms in Quebec. Thus, it has the potential for a balkanizing effect on the Canadian capital market, because any extra total gross saving induced by the plan can flow only into investment carried out by firms located in Quebec. If these firms are rivals to non-Quebec firms in product markets, the plan could injure the latter. It could also induce firms to locate or relocate in Quebec, rather than elsewhere. Thus it could, in theory, be attacked as a type III barrier.

Any injury the QSSP causes to firms outside Quebec would, however, probably be difficult to quantify or even to demonstrate in practice. If the program is successful in targeting new and developing firms that are first into an emerging industry, the question of harm to competitors is moot. If it succeeds in luring investment to Quebec rather than elsewhere, other jurisdictions could indeed claim to be injured, and conventional economic theory would hold that such injury was also an inefficiency. But increasing-returns economics substantially discounts this concern. Many investment location decisions cannot be understood as efficient exploitations of comparative advantage; rather, much manufacturing and processing investment is "footloose" in the sense that its location may be determined by chance or by forces of agglomeration rather than by fundamental comparative advantage. Therefore, the charge of inefficiency should probably not be levied against a plan such as the QSSP.

Although a plan such as the QSSP fits the definition of a type III barrier, it should not, in my view, be a target of legal attack. It is not that such plans have a high probability of success. Indeed, only

experience can tell whether or not they work. While experience accumulates, the sponsoring governments, and ultimately the taxpayers, foot the costs. These costs provide significant self-monitoring; the program will die if its benefits do not outweigh them.

The Caisse de dépôt et placement du Québec

The Caisse de dépôt et placement du Québec was formed in 1966 and has grown to be the largest manager of pension funds in Canada. When observers discuss the complex of government-corporate relations in Quebec, the Caisse is usually the first institution cited.

Although established under provincial legislation and ruled by a nine-member board of directors appointed by the government for fixed terms,[29] the Caisse is an autonomous institution. For example, the chairman cannot be removed without the agreement of two-thirds of the Quebec National Assembly and the security of the tenure of board members strengthens its independence. Nevertheless, the Caisse is a creature of the provincial government as the appointment rules and the nature of its legislated mandate make clear.

The enabling legislation gives the Caisse a dual mandate: (1) the fiduciary goal of optimizing its financial return on behalf of its depositors; and (2) the public policy goal of contributing to Quebec's economic development. One aspect of the latter is to overcome a perceived market failure in the supply of capital to small, less well established firms.

What are the implications of these mandates, particularly the latter, for capital mobility in the Canadian economic union? Before looking for an answer, we should recall that the question is of real concern. The Caisse is huge. It manages the deposits of the Quebec Pension Plan and 15 other public pension and insurance funds as well as those of some private sector plans, such as that of the Quebec

29 The board has three nonvoting members: the deputy minister of finance, a senior official of Hydro-Québec, and one member of the Municipal Commission of Quebec or an officer of the Ministry of Municipal Affairs.

construction industry. From its standing start in 1966 with an asset size of $174 million, the Caisse had grown to a book value of $33.6 billion at the end of 1989[30] — an average increase of $1.4 billion per year. During the same period, the Quebec economy generated an average flow of net saving of $7.3 billion per year. Thus, almost 20 percent of that economy's generation of net saving has flowed into the asset pool managed by the Caisse since its inception.[31] These magnitudes are large enough to cause concerns over potential effects on the flow of capital and the location of investment.

Economic analysis of public policies such as the Caisse have addressed the potential conflict between the fiduciary goal and the economic development goal: if a provincial public sector pension fund uses its investments to try to promote economic development within the province, the fund's assets may earn a lower return or bear greater risk than if it attempts only to achieve the best risk/return combination possible. James Pesando's study of government investment corporations contains probably the best analysis of this conflict,[32] emphasizing the potential costs of policies that deviate from a strict pursuit of fiduciary goals. Suppose the Caisse desires, in pursuit of its economic development goal, to increase the amount of investment carried out by firms in Quebec. Pesando distinguishes between small firms that may have imperfect access to the capital market and large firms whose debt and equity securities are publicly

30 Book value, rather than market value, gives a better measure of the accumulated flow of savings into the Caisse because the former is not distorted by capital gains or losses.

31 Readers unfamiliar with the terminology of accounting might pause to recall here that net saving is gross saving — the measure I used in the discussion of saving and investment rates — minus depreciation of the capital stock. The difference between gross and net saving is exactly the same magnitude as the difference between gross and net investment. The reason for using net measures in this discussion is that I am discussing accumulation over time. As long as the depreciation estimate is reasonable, net saving better reflects accumulation as it allows for wear and tear on the capital stock.

32 James E. Pesando, "An Economic Analysis of Government Investment Corporations, with Attention to the Caisse de dépôt et placement du Québec," Economic Council of Canada Discussion Paper no. 277 (Ottawa, March 1985).

traded on organized exchanges. In the former case, below-market-rate loans can be effective in increasing investment as long as the loans represent the firms' marginal source of funds. Things are different in the case of large firms.[33] Mere ownership of these firms' securities does not have any long-term effect on their costs of capital and is thus unlikely to stimulate investment. Pesando concludes that the Caisse must pursue substantial equity ownership of such target firms with the intent of having its directors adopt some managerial control over them so it can influence their investment decisions.

What effects follow? "If the Caisse sought, for example, to direct real investment to the province of Quebec which is not justified on purely economic grounds, then the market value of the firm's shares ...must fall,"[34] Pesando says, as a result from both a reduction in the expected cash flows of the target firms, and an increase in their costs of capital.[35] These effects would pertain, Pesando points out, not only to firms actually targeted by the Caisse but to all potential target firms as well. Thus, the shareholders of these firms would incur windfall losses. Also, the higher cost of capital would reduce the rate of investment, thereby making the capital stock lower than it would otherwise be and placing the economy on a lower growth path.

Pesando's analysis of conflicts between fiduciary and economic development pursuits is correct on its own terms and should be a useful caution to the activities of public sector pension funds such as the Caisse. It does not, however, appear to provide a strong case for treating such policies as type III barriers that threaten the integrity of the economic union.

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33 Notice that the problem is partly one of targeting, which figured in discussion of the QSSP.

34 Pesando, "An Economic Analysis," pp. 3-8, 3-9.

35 The expected cash flow effect is straightforward: real investment has been redirected toward lower rate-of-return activities. The expected cost of capital effect is more subtle. The level of uncertainty attaching to potential target firms is increased by the risk that their investment decisions may, at some point, be influenced by the Caisse's economic development goal. This uncertainty represents an increase in these firms' systematic risk — as long as the aggregate market value of potential target firms is not a trivial proportion of total market value. This risk cannot be diversified away, so the required rate of return on the shares of all potential targets goes up.

First, the analysis implicitly assumes that information is a free good, at least as far as large firms are concerned. All possible investment projects that can justify their costs are assumed to have been carried out, and thus any deviation from this line of activity can only lower society's wealth. Yet information is rarely free — or perfect.

Also, Pesando assumes that agency problems — the pursuit of goals that are not wealth maximizing — arise only when people from the public sector become members of the board of directors. Yet as modern financial economics has clearly established, agency problems are endemic to all organized effort, whether it takes place in the private or the public sector. They result from information failures and the costs of monitoring.

In fact, since the Caisse must pay attention to the needs and directives of its depositors, it is far from free to pursue a reckless economic development agenda. Moreover, the harm that Pesando's analysis ascribes to an economic development goal is its own discipline on the activities of the Caisse. The bulk of any evaporation of equity value or reduction in investment resulting from those activities would most likely be felt *within* Quebec. Any provincial government interested in its own political survival, not to mention the well-being of its province, would not ignore such market disciplines.

The Alberta Heritage Savings Trust Fund

The Alberta Heritage Savings Trust Fund ("the Heritage Fund") is another high-profile provincial institution that might be said to influence capital mobility in Canada. Founded by an act of the Alberta legislature in 1976, the Heritage Fund was created as a public policy device for managing Alberta's oil wealth.[36] Its goals are to save for the future, to strengthen and diversify the economy of the

36 The legislature's original stipulation was that the fund receive 30 percent of Alberta's revenue from nonrenewable resources. When the recession of the early 1980s resulted in a provincial budget deficit, the contribution rate was halved to 15 percent beginning with the 1983/84 fiscal year and the investment income generated by the fund was no longer reinvested in it but was diverted to general...

province, and to improve the quality of life for Albertans. The Heritage Fund's total financial assets peaked at $12.75 billion at the 1986/87 fiscal year end and stood at $12.13 billion as of March 31, 1991.[37] The only significant investments it held outside Alberta were provincial government or government-guaranteed debentures, mostly from the Atlantic provinces. They totaled $1.19 billion on March 31, 1991, representing 9.8 percent of its financial assets.

Superficially, the Heritage Fund resembles Quebec's Caisse de dépôt as a public policy: in both cases, a sizable investment pool is managed and there is an economic development goal as well as a saving goal. The Heritage Fund's "deposits" were, however, derived from provincial government revenue, rather than from the pension contributions of employees. Thus, the Heritage Fund does not have as strong a fiduciary objective as the Caisse; it is a device for managing a component of the provincial government's tax revenues, an extension of Alberta government fiscal policy.

Does the Heritage Fund have an important effect on capital mobility in Canada? Its investments are not geographically well diversified. Although 72 percent of its assets are in fairly liquid fixed-income instruments, such as bonds and debentures, almost all of them are issues of Alberta-based public sector and private sector organizations.[38] This investment policy probably does raise both saving and investment in Alberta's economy. This effect is probably not very large, however. Between the year the Heritage Fund was founded and 1989, the Alberta economy generated approximately $99.8 billion in accumulated net saving. As Figure B-4 shows, those

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Note 36 - cont'd.

...government revenues. When the oil price collapse of 1986 severely reduced Alberta's resource revenues, contributions to the fund ceased. Since then the fund's size has held roughly constant in current dollars; in inflation-adjusted dollars, it has been shrinking.

37 There are also some "deemed assets" — expenditures on infrastructure and other projects of a public nature that do not necessarily generate a financial return. The total of financial and deemed assets was $15.33 billion as of March 31, 1991.

38 Peter J. Smith, "The Politics of Plenty: Investing Natural Resource Revenues in Alberta and Alaska," *Canadian Public Policy* 17 (June 1991): 139–154.

years (at least up to 1981) were a period of very high saving rates in the province. Of the total, $33.6 billion, or 33.7 percent, was accounted for by the public sector — not including the federal government, whose balance for Alberta was positive. Meanwhile, the Heritage Fund's Alberta investment activities accounted for roughly 14 percent of total accumulated net saving in the province. Thus, the fund probably does not have a significant effect on balance of payments mobility of capital in Alberta.

The major effect on capital mobility arising from Alberta's resource endowment is clearly in the form of migration mobility. The advantages and disadvantages of migration induced by large and variable natural resource revenues have been analyzed by many Canadian economists.[39] Alberta's overall fiscal policy must deal with the issue. The Heritage Fund is incidental as a device within that policy.

Thus, the answer to the final question concerning the Heritage Fund — can it be viewed as a type III barrier to capital mobility that uses subsidies to lure or influence the location of investment within Canada? — clearly appears to be no. Any influence or lure to investment in Alberta arises from the presence of large natural resource revenues, whether or not they are managed by a device such as the fund. That these revenues allow the provincial government to provide a relatively expensive range of public services with a lower tax structure is a fundamental lure to migration — which, of course, operates only when resource prices are favorable — and has nothing to do with a policy such as the fund.[40]

Summary

The foregoing discussion of public policies that create potential type III barriers will probably strike some readers as too soft on their

39 The February 1980 edition of *Canadian Public Policy*, which is devoted to analysis of the Heritage Fund, examines these issues closely.

40 The Canadian Constitution has a means of mitigating "fiscally induced migration": the equalization program. However, natural resource revenues are not presently included in the revenue bases that are equalized.

beggar-thy-neighbor attributes. Do not capital-oriented subsidy policies risk a subsidy war between provinces that transfer too much wealth to the subsidized corporate sector at the expense of unsubsidized corporations and the general taxpayer? Has not the European Community (EC) found it necessary to adopt a strict subsidies code that attenuates the ability of member countries to offer them? Will not Canada face the same necessity if it renews itself into a more decentralized federation?

The methods of regulating subsidies in the EC, the United States, and the members of the General Agreement on Tariffs and Trade are surveyed in a 1983 paper by Warren F. Schwartz.[41] The EC has the strictest subsidy policy — it simply prohibits them, albeit with a number of exceptions, such as aid to the economic development of poor regions. Canada does not have any code or regulation limiting subsidies offered by the federal or provincial governments. This contrast at first seems paradoxical: the more integrated economic union does not guard against subsidies whereas the less integrated common market does. The explanation may lie in the nature of Canada as a federal state: it has a national interest that differs from the sum of the individual interests of the federated provinces. From the perspective of that national interest, policies that may influence the location of investment are not a problem as long as the investment occurs within the nation. Exactly where in the nation does not matter much, aside from regional development concerns — which all nations confront. Indeed, some subsidy policies may help investment find its best location. Subsidy offers may reflect information held by provinces' governments that is not held by the potential investor looking for the best site. In other words, when information is not free and equally available to everyone, some subsidy competition between provinces could be "efficient."

Much less of a supranational interest is at work in a confederal setting such as the EC, although the "Europe 1992" program and

41 Warren F. Schwartz, "Regulation of Industrial Subsidies in the EEC, the United States, and GATT," in Michael J. Trebilcock et al., eds., *Federalism and the Canadian Economic Union* (Toronto: Ontario Economic Council, 1983).

future efforts to integrate may help strengthen it. A group of separate national interests have joined together to attempt to secure gains from greater economic integration. The location of investment is of vital concern to each national interest, so beggar-thy-neighbor policies can be seen only as significant threats. In order to secure at least some benefits from closer economic integration, the potential members must come to the bargaining table prepared to mutually commit themselves not to use these policies. Since a confederal arrangement exists only as long as the member states will it, all of the mutual benefits of economic integration can be lost if members decide that the union does not function to benefit their several national interests. Consequently, the commitment to relinquish weapons such as subsidies — or at least to subject them to a strict code — is vital to the continuation of the whole arrangement.

The Canada-U.S. Free Trade Agreement (FTA) is the exception that proves the rule. The FTA represents a lower order of integration than the EC but has no subsidies code. Recall, however, that this lack is not for want of trying. Negotiators attempted to include a code in the FTA but could not agree on what it should be like.[42]

Canada, with its national ties that bind, can likely continue to exist without a subsidies code. An important aspect of the federal setting is the existence of an integrated fiscal transfer system, which, in Canada's case, includes a formal equalization program. Equalization helps to level the playing field and to give the less wealthy participants some assurance that they will not be completely defeated by the wealthy participants in a subsidy competition. One could argue, however, that if Canada becomes an even more decentralized federation, the distinct national interest would be weaker, and the separate provincial interests stronger. Canada would be in a position similar to that of the EC. A subsidies code might be one of the prices that individual provinces would have to pay in order to secure the other benefits of economic union. One could also argue that if constitutional renewal leads to fewer type I and II barriers to

42 The FTA left subsidies as unfinished business to be dealt with by 1995.

trade in goods and services, provincial governments' incentives to use type III subsidies as a lure to investment may rise. For example, a reduction in barriers to interprovincial trade in beer will allow breweries to rationalize, making for a smaller number of larger plants. There will no longer necessarily be a plant in each province. Thus, the urge to attract plants to a given province will be higher, and subsidy competition could ensue. A subsidies code might help to lessen this competition and prevent disagreements that would threaten other gains to economic integration.

Should Canadians plan in advance for such scenarios by drafting an economic union provision that strongly prohibits type III barriers? I think not. Necessity is the mother of invention, and in this case the necessity has not arisen yet. Right now, any attempt to introduce such a prohibition via the Constitution would only make more difficult the process of finding agreement on renewed federalism.

Conclusion

In this essay, I have explored the mobility of capital in the Canadian economy and briefly examined some public policies that could be construed to be barriers to capital mobility. Economists have occasionally indicated concerns about the effect of such policies on the efficient allocation of capital. Many Canadians, however, have expressed considerable concern about the meaning of the word "efficiency" and have shown mixed feelings about constitutional proposals that include it. I have tried to show that there is some genuine ambiguity about the meaning of the word. Efficiency and market forces are extremely important. Witness the travails of the former communist countries of eastern Europe that are attempting to create market economies. Capital mobility has contributed to tremendous generation of wealth in the Canadian economy. Some barriers to capital mobility do exist in the form of public policies, such as public sector pension funds, industrial policies, and tax incentives targeted at particular saving instruments. These barriers attempt to redirect the flow of financial capital and/or the location of physical invest-

ment from what they otherwise would be. To assert that "what they otherwise would be" would be efficient and that what does result from them is inefficient is unhelpful and probably inaccurate.

These barriers do not create enough harm to warrant legal scrutiny today. Moreover, a good case can be made that some of them have beneficial effects. When these policies fail, that fact informs subsequent policy, and our federal system permits experience to accumulate on a small scale before it is applied generally. Finally, these policies have costs that are at least in part — quite possibly, in the greatest part — borne by the taxpayers whose governments pursue them. Therefore, they are self-regulated to a considerable extent.

Nonetheless, capital mobility should be entrenched in the Constitution because to leave it out while including the other three freedoms (goods, services, and people) would invite attempts to establish protectionist barriers to these other mobilities via the capital loophole. But the touchstone should not be efficiency. We have available alternative supporting rationales for protection of the economic union that do not suffer the disadvantage of reflecting static economic theory.

Appendix A: Sources and Implications of Increasing Returns

The notion of increasing returns has been around for quite some time but has only recently been the focus of intensive research in economics.[43] Brian Arthur suggests four fundamental sources:

> Large set-up or fixed costs (which give the advantage of falling unit costs to increased output); learning effects (which act to improve products or lower their costs as their prevalence increases)...; coordination effects (which confer advantages to "going along" with other economic agents taking similar action); and adaptive expectations (where increased prevalence on the market enhances beliefs of further prevalence).[44]

When such forces are prevalent — and they seem to be pervasive in modern, sophisticated economies — market forces do not work in quite the same ways as they do in conventional economics. Several unusual properties emerge, including:

- *Multiple equilibria.* The winner of a competition between two technologies, such as Betamax and VHS, Japanese and U.S. high-definition television, or light-water-cooled and heavy-water-cooled nuclear generating plants, cannot be predicted in advance. The contest can go either way. One way in which the competition is decided is one technology's getting a head start. It then benefits from increasing returns. Thus, if VHS gets an early lead in market share, video store owners tend to stock more cassettes in VHS format, thus increasing consumers' in-

43 This section draws on W. Brian Arthur, "Self-Reinforcing Mechanisms in Economics," in P.W. Anderson, K.J. Arrow, and D. Pines, eds., *The Economy as an Evolving Complex System*, SFI Studies in the Sciences of Complexity (Redding, Mass.: Addison-Wesley, 1988).

44 Ibid., p. 10.

centive to choose VHS video machines. VHS's early lead is reinforced. And so on.

- *Possible inefficiency*. There is no guarantee that the inherently "better" technology will be the winner of the contest. If the inferior one gets a head start, "the eventual outcome may not be of maximum benefit."[45]
- *Lock-in*. Once a winner is determined, it may be very difficult to rerun history and overturn the result. Thus, any inefficiencies may become locked in.
- *Path dependence*. Victory in such competitions is often the result of historic accident — small events and chance circumstances. Historic accident is, for example, frequently the only explanation for the location of significant industrial clusters in one place rather than another.

Arthur points out that conventional economic concepts of diminishing returns, market forces, and efficiency were developed

> 100 years ago during an age of agriculture and bulk-manufactured goods....Expansion of production of any one product — say wheat or steel — could easily come into resource limitations. Products thus faced "diminishing returns" and they came into a balance — an equilibrium — when these scarcities equalized. The market solution was predictable, and was also the best outcome that could be achieved given the available resources, as long as government did not interfere.[46]

In other contexts, particularly those involving long-term development and high-tech competition, things may be different. Historically long-lived forces of economic development can reflect a lock-in of initial advantages, rather than optimal resource allocation.[47] And

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45 Ibid.

46 Brian Arthur, "An Imperfect Fit," *Signals*, Spring 1991, p. 10.

47 For another application of this notion in a closely related context, see John McCallum and Chris Green, *Parting as Friends: The Economic Consequences for Quebec*, The Canada Round 5 (Toronto: C.D. Howe Institute, 1991). Chapter 5 and Appendix B discuss path-dependent behavior in economic geography in the context of the development of the economy of Montreal.

it is possible for market forces to lead to poor choices in technological competition:

> If any government wants to compete successfully in this unstable world of high-tech competition, it needs to go beyond the standard "no hands approach."...The...government should not necessarily subsidize and protect new industries in the hope of capturing foreign markets. Often this means money wasted on government white elephants.[48]

But some forms of government influence may be beneficial. Nicholas Kaldor, writing in 1972, gave the following provocative summary of the potential implications for economic theory arising out of increasing returns and positive feedbacks:

> When every change in the use of resources — every reorganization of production activities — creates the opportunity for a further change which would not have existed otherwise, the notion of an "optimum" allocation of resources — when every particular resource makes as great or greater contribution to output in its actual use as in any alternative use — becomes a meaningless and contradictory notion: the pattern of the use of resources at any one time can be nor more than a link in the chain of an unending sequence and the very distinction, vital to equilibrium economics, between resource-creation and resource-allocation loses its validity. The whole view of the economic process as a medium for the "allocation of scarce means between alternative uses" falls apart — except perhaps for the consideration of short-run problems.[49]

48 Arthur, "An Imperfect Fit," p. 13.

49 Nicholas Kaldor, "The Irrelevance of Equilibrium Economics," *The Economic Journal* 82 (December 1972): 1245.

Appendix B:
Saving and Investment in OECD Countries, Canada, and the Provinces

Table B-1: ***Twenty-Two OECD Countries: Ratio of Saving and of Investment to GDP, 1960–87***

	1960–87			1960–70		1971–80		1981–87	
	Saving	Investment	Difference	Saving	Investment	Saving	Investment	Saving	Investment
Australia	23.0	25.9	–2.9	24.8	27.2	23.7	25.1	19.3	25.1
Austria	26.8	27.2	–0.4	28.0	28.0	27.6	28.7	23.8	23.9
Belgium	20.5	20.5	0.0	22.6	22.0	21.8	22.0	15.2	16.0
Canada	21.9	23.7	–1.8	21.8	24.0	23.1	24.7	20.3	21.6
Denmark	20.1	22.9	–2.8	23.2	25.2	20.3	23.2	14.8	18.7
Finland	25.6	27.2	–1.6	25.6	27.0	26.7	28.8	24.1	25.1
France	24.3	24.0	0.3	26.3	25.4	25.4	25.2	19.6	20.1
Greece	21.2	24.2	–2.9	19.7	22.7	26.2	28.1	16.5	20.8
Iceland	23.3	26.5	–3.1	25.3	27.0	24.7	28.8	18.3	22.3
Ireland	19.4	24.1	–4.7	18.6	20.6	21.0	27.4	18.3	25.0
Italy	19.0	18.8	0.2	21.0	19.5	19.2	19.4	15.6	16.7
Japan	33.8	33.1	0.7	35.0	35.1	34.4	33.8	31.1	29.0

Table B-1 - *continued*

	1960–87			1960–70		1971–80		1981–87	
	Saving	Investment	Difference	Saving	Investment	Saving	Investment	Saving	Investment
Netherlands	24.7	23.4	1.3	26.9	26.7	23.9	22.7	22.2	19.1
New Zealand	21.5	25.6	-4.2	21.2	24.5	21.8	26.1	21.5	26.8
Norway	27.5	29.8	-2.3	27.5	29.4	27.0	32.2	28.2	27.1
Portugal	24.4	27.0	-2.7	23.9	24.7	25.6	28.8	23.4	28.2
Spain	24.0	24.2	-0.2	25.5	25.2	25.0	25.8	20.3	20.5
Sweden	21.7	22.3	-0.6	25.0	25.3	21.1	21.7	17.2	18.3
Switzerland	28.6	26.8	1.9	29.6	29.8	28.0	25.5	28.0	23.8
United Kingdom	18.2	18.6	-0.4	18.7	19.0	18.1	19.6	17.5	16.6
United States	18.7	18.8	-0.1	19.6	18.8	19.5	19.3	16.3	18.1
West Germany	24.6	23.7	1.0	27.3	26.6	23.7	23.0	21.8	20.0
Average absolute difference			*0.8*		*1.5*		*1.3*		*1.2*

Note: Ratios were calculated using gross saving and gross investment. The use of net data would have resulted in smaller ratios but the same difference between them for each year.

Source: Organisation for Economic Co-operation and Development, annual national accounts as presented in Andrew Dean et al., "Saving Trends and Behaviour in OECD Countries," OECD Department of Economics and Statistics working paper 67 (Paris, June 1989).

Table B-2: ***Provinces and Canada: Ratio of Saving and of Investment to GDP, 1961–89***

(federal government amounts included)

	1961–89			1961–74			1975–89		
	Gross Saving	Gross Investment	Difference	Gross Saving	Gross Investment	Difference	Gross Saving	Gross Investment	Difference
Newfoundland	–7.1	35.9	–43.0	–2.8	42.8	–45.6	–11.0	29.4	–40.4
Prince Edward Island	–22.3	27.3	–49.6	–25.3	31.3	–56.6	–19.4	23.5	–42.9
Nova Scotia	–11.7	26.2	–37.9	–8.9	27.4	–36.3	–14.3	25.0	–39.3
New Brunswick	–2.6	28.5	–31.1	–0.3	29.3	–29.6	–4.7	27.7	–32.4
Quebec	19.2	20.6	–1.4	22.5	20.9	1.6	16.1	20.3	–4.2
Ontario	25.9	20.4	5.5	26.1	21.1	5.0	25.7	19.7	6.0
Manitoba	15.1	22.7	–7.6	17.3	25.2	–7.9	13.2	20.5	–7.3
Saskatchewan	20.9	27.4	–6.5	21.3	27.3	–6.0	20.5	27.6	–7.1
Alberta	30.8	29.9	0.9	25.9	30.6	–4.7	35.4	29.2	6.2
British Columbia	21.9	25.2	–3.3	22.1	27.7	–5.6	21.7	22.8	–1.1
Canada	21.3	23.0	–1.7	21.8	23.7	–1.9	20.9	22.4	–1.5
Average of absolute differences for provinces			*18.7*			*19.9*			*18.7*

Note: Ratios were calculated using gross saving and gross investment. The use of net data would have resulted in smaller ratios but the same difference between them for each year.

Source: Statistics Canada, *Provincial Economic Accounts*, Cat. no. 13-213; and author's calculations (see Appendix C).

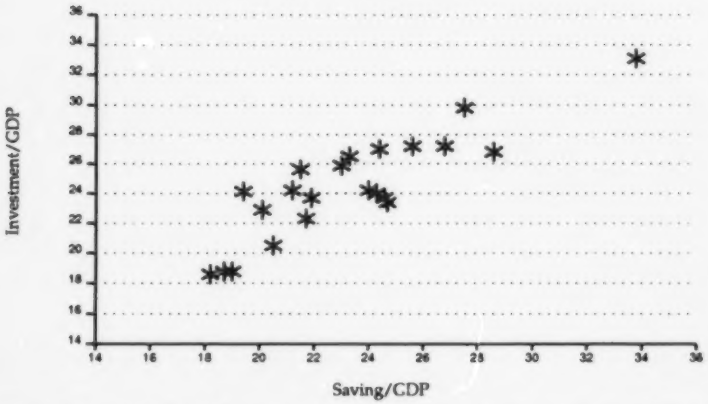
Table B-3: ***Provinces:***
Ratio of Saving and of Investment to GDP, 1961–89
(federal government amounts excluded)

	1961–89			1961–74			1975–89		
	Gross Saving	Gross Investment	Difference	Gross Saving	Gross Investment	Difference	Gross Saving	Gross Investment	Difference
Newfoundland	19.8	34.2	-14.4	18.0	40.8	-22.8	21.4	28.0	-6.6
Prince Edward Island	14.5	25.4	-10.9	7.6	28.6	-21.0	21.0	22.4	-1.4
Nova Scotia	14.8	24.6	-9.8	13.0	25.8	-12.8	16.5	23.4	-6.9
New Brunswick	19.0	27.8	-8.8	16.0	28.5	-12.5	21.8	27.1	-5.3
Quebec	20.9	20.2	0.7	20.0	20.5	-0.5	21.9	19.9	2.0
Ontario	23.6	20.0	3.6	21.7	20.6	1.1	25.4	19.4	6.0
Manitoba	22.6	21.9	0.7	21.7	24.0	-2.3	23.4	19.9	3.5
Saskatchewan	28.0	26.8	1.2	28.0	26.5	1.5	27.9	27.0	0.9
Alberta	27.5	29.5	-2.0	24.7	30.1	-5.4	30.1	28.9	1.2
British Columbia	20.9	24.7	-3.8	19.7	27.2	-7.5	22.1	22.4	-0.3
Average of absolute differences for provinces			*5.6*			*8.7*			*3.4*

Note: Data on saving and investment are aggregates of public sector and private sector rates. Ratios were calculated using gross saving and gross investment. The use of net data would have resulted in smaller ratios but the same difference between them for each year.

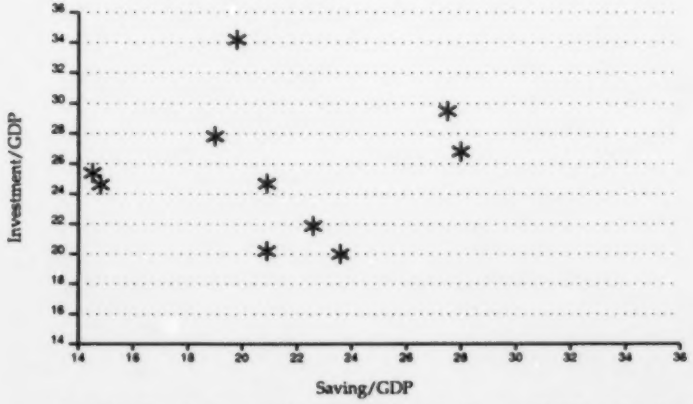
Source: Statistics Canada, *Provincial Economic Accounts*, Cat. no. 13-213; and author's calculations (see Appendix C).

Figure B-1: ***Twenty-Two OECD Countries: Ratio of Saving and of Investment to GDP***
(average percent by country, 1960–87)



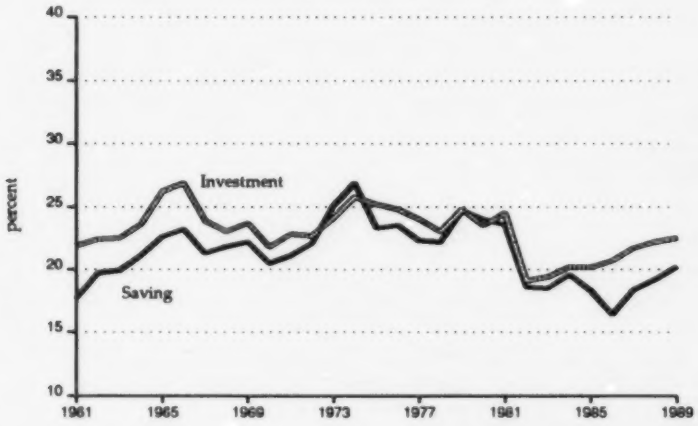
Source: Organisation for Economic Co-operation and Development, annual national accounts as presented in Andrew Dean et al., "Saving Trends and Behaviour in OECD Countries," OECD Department of Economics and Statistics working paper 67 (Paris, June 1989).

Figure B-2: ***Canadian Provinces: Ratio of Saving and of Investment to GDP***
(average percent by province, 1961–89)



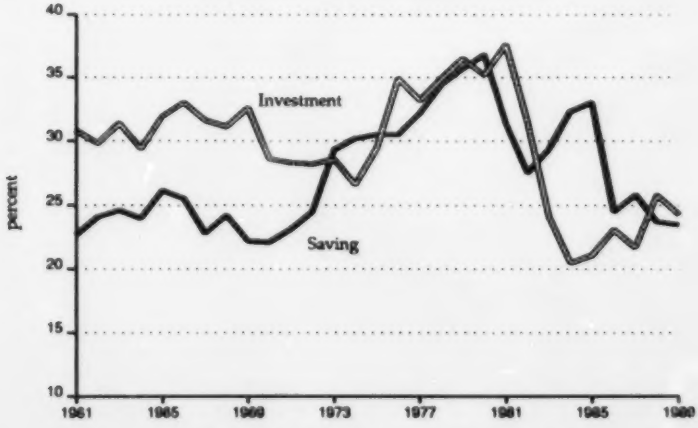
Sources: Statistics Canada, *Provincial Economic Accounts*, Cat. no. 13-213; and author's calculations (see Appendix C).

Figure B-3: ***Canada: Ratio of Saving and of Investment to GDP, 1961–89***



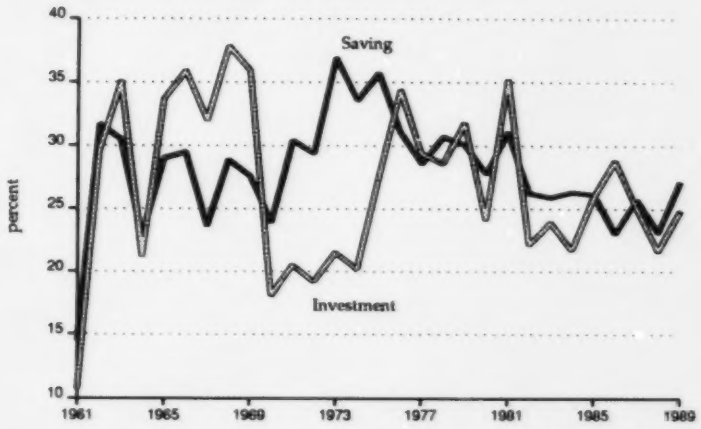
Source: Statistics Canada, *Provincial Economic Accounts*, Cat. no. 13-213; and author's calculations (see Appendix C).

Figure B-4: ***Alberta: Ratio of Saving and of Investment to GDP, 1961–89***



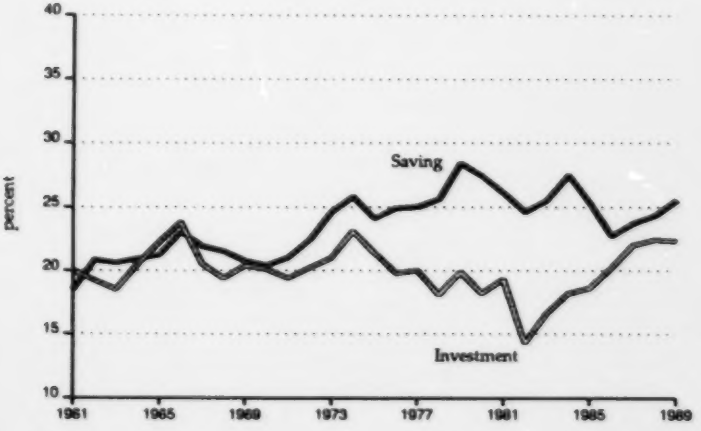
Source: Statistics Canada, *Provincial Economic Accounts*, Cat. no. 13-213; and author's calculations (see Appendix C).

Figure B-5: ***Saskatchewan: Ratio of Saving and of Investment to GDP, 1961–89***



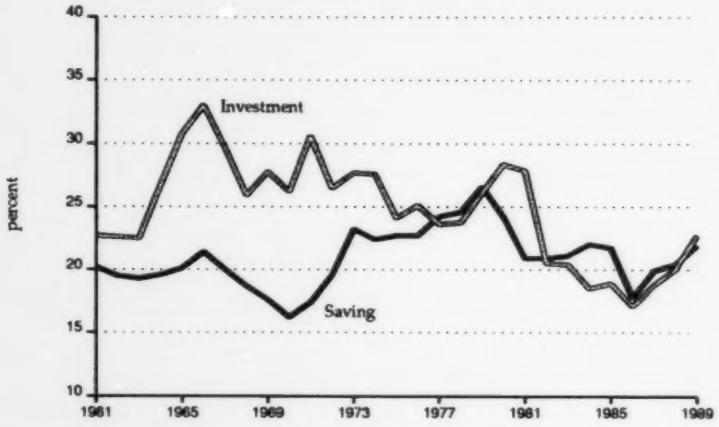
Source: Statistics Canada, *Provincial Economic Accounts*, Cat. no. 13-213; and author's calculations (see Appendix C).

Figure B-6: ***Ontario: Ratio of Saving and of Investment to GDP, 1961–89***



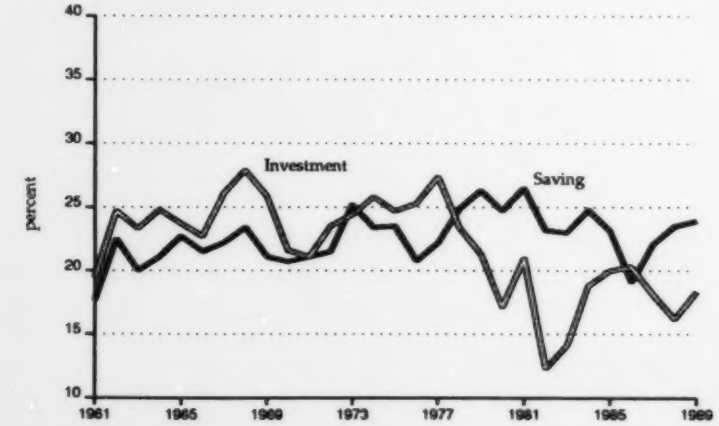
Source: Statistics Canada, *Provincial Economic Accounts*, Cat. no. 13-213; and author's calculations (see Appendix C).

Figure B-7: *British Columbia: Ratio of Saving and of Investment to GDP, 1961–89*



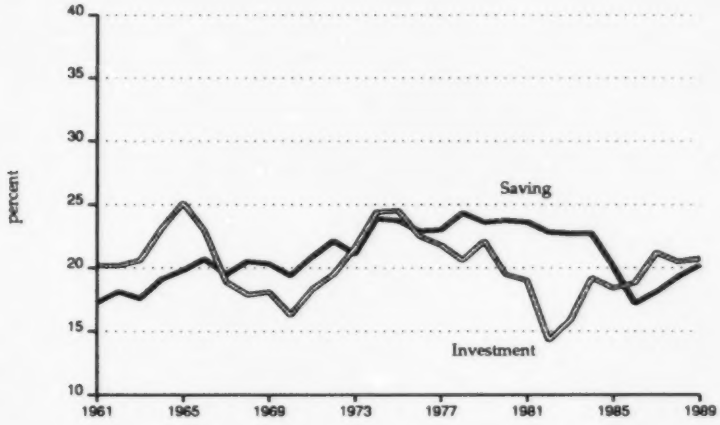
Source: Statistics Canada, *Provincial Economic Accounts*, Cat. no. 13-213; and author's calculations (see Appendix C).

Figure B-8: *Manitoba: Ratio of Saving and of Investment to GDP, 1961–89*



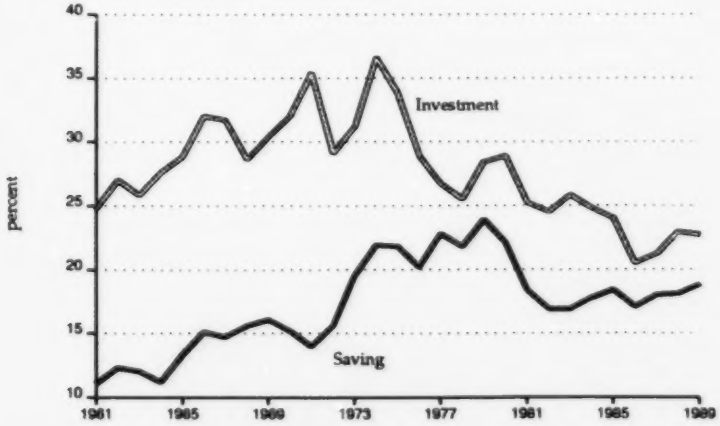
Source: Statistics Canada, *Provincial Economic Accounts*, Cat. no. 13-213; and author's calculations (see Appendix C).

Figure B-9: ***Quebec: Ratio of Saving and of Investment to GDP, 1961–89***



Source: Statistics Canada, *Provincial Economic Accounts*, Cat. no. 13-213; and author's calculations (see Appendix C).

Figure B-10: ***Atlantic Provinces: Ratio of Saving and of Investment to GDP, 1961–89***



Source: Statistics Canada, *Provincial Economic Accounts*, Cat. no. 13-213; and author's calculations (see Appendix C).

Appendix C: Calculating Balance of Payments Data for Canadian Provinces

Like most countries, Canada does not keep track of the current account balances of subnational jurisdictions such as provinces. I was, however, able to estimate them for this study, using data from the *Provincial Economic Accounts* (PEA)[50] for 1961 to 1989.

The first part of this appendix explains some assumptions I made in my calculations. The second develops accounting identities to support the use of the PEA data and to clarify the manner in which federal balances affect the system.

The PEA Data: Assumptions

The PEA are not as complete or fine as the national accounts. They are sufficient to estimate the provinces' current account balances, though not the components thereof, via the saving-investment identity if one constructs proxies for two components — one in personal saving and one in corporate saving — that are not shown in the data. The methods used to construct the proxies are as follows:.

- *Personal sector CCA charges.* The PEA do not provide an estimate of capital consumption allowances (CCA) for the persons and unincorporated business sector. Thus, to estimate net saving, it was necessary to allocate by province the *National Income and Expenditure Accounts* (NIEA) measure of CCA charges for this sector. This allocation was done using residential construction data from the PEA. Each province's percentage share of residential construction spending, time aggregated from 1961 to 1989, was computed, and this percentage weight was applied to the national CCA measure, providing a proxy for the provin-

50 Statistics Canada, Cat. no. 13–213. In this essay, I have used the data that were available at the time of publication of the PEA Annual Estimates, 1985–89.

cial CCA charge. Having this estimate of personal sector CCA then allowed me to estimate corporate sector CCA by taking total CCA and deducting the government sector figures — which are included in the PEA — as well as the personal sector estimate.

- *Corporate-sector saving*. The PEA do not report corporate sector saving, so it was necessary to construct a proxy measure using elements of the PEA and the NIEA accounts. First, I constructed a measure of corporate cash flow by subtracting direct taxes from corporate before-tax profit and then adding back the corporate CCA measure. From the national accounts, I created a national dividend payout ratio,[51] which I applied to the cash flow measure. The difference between cash flows and payouts is the measure of corporate saving. In other words, provincial corporate saving is proxied using provincial corporate cash flows and a national, rather than a provincial, dividend payout ratio.

No inflation correction was attempted. It is worth remembering, however, that inflation may distort the saving-investment calculations by overstating the income of recipients of interest income from nonindexed assets — since part of the interest payment is compensation for the erosion of real value of the principal. Thus, net lenders have overstated income and saving while net borrowers have understated them.

Saving and Investment Accounting Identities in the Canadian Federal Context

This section provides conceptual support for the calculations underlying Tables B-2 and B-3 by developing accounting identities that

51 The dividend payout ratio was computed as the ratio of dividends and other payments out of corporation profits after taxes (withholding taxes, bad debts, and charitable and other contributions) to retained cash flows (measured as undistributed corporation profits plus CCA).

link the current account, saving, and investment by province while dealing with the tricky issue of the federal balances.

From the PEA data and the calculations just described, I constructed two versions of the provincial current account. In the first, a province's current account surplus is the sum of the private, provincial public, and federal public components of saving, less investment. The results are summarized in Table B-2. For the second, the definition of the current account was amended to exclude the federal component of saving (Table B-3).

The PEA treat the federal government as a resident of each province, whereas this study views it as an outsider whose spending, taxing, and transfer policies are alternately unilateral transfers (Table B-3) or capital inflows (Table B-2). Of course, the federal government really is a resident in each province and its employees there earn salaries that count as resident income. This fact does not, however, pose a problem for the study. One can still think of federal purchases of goods and services as "export" sales by the provinces and of federal taxes and transfers as other items in the provinces' "balance of payments."

Some observers refer to federal transfers as capital inflows that help to finance the current account deficits of the "have-not" provinces. They are, however, more appropriately viewed as unilateral transfers, thus falling under the current account rather than the capital account, as they carry no obligation to pay back.[52]

A final comment on the quality of the federal balances data is in order. Statistics Canada views these data as containing considerable errors, although it is confident that the errors are in the same direction year after year. This is another reason for preferring the Table B-3 measures, which exclude federal balances.

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52 Only under a scenario combining a breakup of Confederation and the ascendancy of the historical benefits approach to division of federal assets and debt would it be appropriate to view the transfers as net capital inflows giving rise to payback obligations. Although the breakup of Confederation cannot be ruled out as a possibility, the practical implications of the historical benefits approach must be viewed as limited simply because the transfer recipients would never be able to repay the value of past transfers.

Definitions of Provincial Product and Provincial Income

"Domestic" and "national" concepts of provincial product are related as follows:

$$GNPP = GDPP + F,$$

where GNPP is gross national provincial product, GDPP is gross domestic provincial product, and F is net payments to factors of production — wages, interest, and dividends — from outside the province. (Because the domestic concept includes only the value of production occurring within the boundaries of the province, it is necessary to add net factor payments from outside the province in order to arrive at the national concept of gross production.)

The definition of gross national income is

$$GNPI = GNPP + R,$$

where R is unilateral transfers from outside the province. In the accounts of many nations, foreign aid would be included here. But in the context of the Canadian federation, R includes interregional transfers such as equalization, Established Programs Financing, payments under the Canada Assistance Plan, unemployment insurance benefits, Old Age Security, and Guaranteed Income Support. Thus, transfers are defined as

$$R = EQ + EPF + CAP + UI + OAS + GIS.$$

The definition of federal saving — also called "the federal balance" — in the province is

$$S_f = T_f - G_f - R$$

where S_f is gross federal saving in the province (gross because CCA is added back in), T_f is federal taxes raised in the province, and G_f is

federal goods and services purchased in the province. (From the province's perspective, G_f acts like an export.) G_f also includes the province's allocated share of interest on the federal debt.[53] Provincial residents who hold federal debt receive this interest income in return for their "export" of capital services to the federal government.

GNPI is gross national provincial income. It is the sum of all income flowing to persons and corporations resident in the province in question. Thus, when unilateral transfers, R, are added to GNPP, the result is gross national provincial income.

Saving and Investment

GNPI and GDPP can be disaggregated to derive the saving-investment balance definition of the current account.

Gross national provincial income can be broken down according to its uses:

$$GNPI = C + S_b + T_p + T_f,$$

where C is consumption expenditure, S_b is private saving, T_p is provincial taxes, and T_f is federal taxes. Thus, GNPI can be used to consume, to save, or to pay taxes.

Gross domestic provincial product is exhausted via private consumption and investment purchases (C and I), and government sector purchases, plus net exports:

$$GDPP = C + I + G_p + G_f + X - M,$$

where G_p is provincial government spending, G_f is federal government spending, X is exports, and M is imports.

The following defines the province's current account and then manipulates it to arrive at the saving-investment balance definition of the current account. Notice that this definition of the current account includes no term to account for federal balances; it thus

53 As shown in the *Provincial Economic Accounts*, table 6.

corresponds to viewing federal balances as capital inflows that have to be paid back.

$$CA = X - M + F.$$

Adding $(C + I + G_p + G_f + R)$ to both sides of this equation produces GNPI on the right hand side. Then CA is isolated again on the left-hand side:

$$\begin{aligned} CA &= GNPI - (C + I + G_p + G_f + R), \\ &= C + S_b + T_p + T_f - (C + I + G_p + G_f + R), \\ &= S_b + S_p + T_f - G_f - R - I, \\ &= S_b + S_p + S_f - I, \end{aligned}$$

where S_p is provincial government saving (equal to $T_p - G_p$). This is the equation underlying the results in Table B-2. For a "have-not" province, federal balances, S_f, are negative on average. Thus the current account for such a province has a smaller value than it would under the alternative unilateral transfer view of federal balances.

When the federal government balances are excluded, the implied definition of the province's current account, CA^*, is

$$CA^* = S_b + S_p - I.$$

CA^* does not include S_f and thus reflects a larger surplus for the "have-not" provinces, and a smaller surplus for "have" provinces (as is the case in Table B-3).

These two definitions of provincial current accounts are related:

$$CA^* = CA - S_f.$$

Labor Market Policies and the Jurisdictional Distribution of Powers

Fred Lazar

This paper addresses several specific issues as they relate to the jurisdictional division of powers for labor market policies in training, apprenticeship, occupational licensure, workers' compensation, and occupational health and safety. This list could easily have been extended to include employment standards, labor relations, pay equity, human rights, pension benefits, and bankruptcy. I decided to draw the line for three reasons.

First, space limitations necessitated making a choice among the many government interventions in the labor market.

Second, the economic literature dealing with the policy areas addressed is much richer than the literature on the other subjects. As well, the rationale for government policies on employment standards, labor relations, pay equity, human rights, and bankruptcy seems to be based more on equalizing the relative bargaining strengths of workers and employers than directly on efficiency considerations.

Finally, policies in the areas omitted — except pension benefits and possibly pay equity — do not impede the mobility of capital or labor. They affect the relative price of labor and hence interprovincial and international trade flows. But so too do workers' compensation and occupational health and safety; I see little merit in repeating the analysis by extending it to the other areas.

I would like to thank David Brown, Robyn Elbaum, Eli Katz, Sherylann Lister, and John McCallum for their valuable comments and critiques.

My principal objective is to propose an allocation of responsibility to the federal government or the provinces in each of the areas discussed, an allocation that is appropriate from an economic perspective. Precise allocation may not be practical or feasible in some fields; concurrency and hence cooperation may be more desirable.

The paper is organized as follows. The next section reviews the present constitutional arrangements governing the division of powers for labor market policies. Following is a discussion of the federal government's September 1991 constitutional proposals[1] dealing specifically with labor market interventions. (By and large, they directly consider only training and are ambiguous about the other programs examined here.) The next section reviews the experience in and the lessons of the European Community (EC) and the United States. Then come discussions of the specific areas of interest. The final section of the paper summarizes my key proposals.

In each of the area discussions, the first issue considered is whether there exists an economic justification for that specific form of government intervention in the labor market. If there is no economic role for a particular government initiative, the distribution of powers question is moot.

Generally, economists favor government intervention if it is designed to correct an obvious market failure and if the costs generated by the intervention do not exceed the potential economic benefits. There is no perfect or costless program. If any expenditures are involved, revenues must be collected directly, or indirectly, through the tax system. The means by which the required revenues are raised affects incentives in the market — by influencing savings, the labor supply, and tax-evasion decisions — and thus creates distortions and costs. Recent studies suggest that government creates as much as $0.80 in additional costs for every $1.00 raised in tax.[2] Consequently, the deadweight burden of raising tax revenues to fund government

1 Canada, *Shaping Canada's Future Together: Proposals* (Ottawa: Supply and Services Canada, September 1991).

2 See C. Constantatos and E. West, "Measuring Returns from Education: Some Neglected Factors," *Canadian Public Policy* 17 (1991): 133.

projects should be factored into any evaluation of government intervention. (I do not engage in this exercise in this paper; nevertheless, it is imperative that policymakers perform these calculations.)

Economists may also support government programs that compensate and assist the individuals who bear the brunt of the costs of adjusting to shocks, such as those arising from technological change, trade agreements, currency fluctuations, and changing patterns of global competition. Since adjustment is necessary to capitalize on potential opportunities and economic benefits, compensation may be warranted to facilitate the adjustment process and diminish resistance to change — so long as the benefits exceed the costs. The Economic Council of Canada put forth this exact argument in 1988 when it stated that the acceptability of policy-induced changes might be enhanced and progress hastened by reducing the adjustment costs faced by those individuals bearing their brunt.[3]

If government intervention is merited in an area, I then proceed to determine which level of government should be assigned the responsibility for developing and funding the program. At this stage, I consider several factors: ultimate accountability to the public; decisionmaking responsibility; program delivery responsibility; flexibility and scope for experimentation; and impact on the economic union — in particular, on barriers to the interprovincial mobility of labor. As already suggested, the preferred option may be concurrent jurisdiction, with national standards or objectives established through federal-provincial negotiations or unilaterally by the federal government. In turn, minimum funding levels may be set by the federal government unilaterally, via federal-provincial bilateral agreements, or as a result of a multilateral federal-provincial agreement. Moreover, it may be appropriate to delegate specific program design and/or delivery to the provinces or to subprovincial, regional, or local boards or councils.

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3 Economic Council of Canada, *Back to Basics*, Twenty-Fifth Annual Review (Ottawa: Supply and Services Canada, 1988), at 54.

The Current Constitutional Arrangements

The existing constitutional arrangements, as set out in the *British North America Act*, 1967 (sections 92(13), 92(16), and 93) and as interpreted by the courts, give the provinces jurisdiction in the areas of training and the labor market in general. Yet the federal government, primarily through its spending powers,[4] has been able to become involved in the funding and development of training programs. Indeed, with the introduction of the Canadian Jobs Strategy in 1985 and the Labour Force Development Strategy in 1989, Ottawa has become directly involved in the development and implementation of general labor market policies, as well as training. We now have the federal government and each of the provincial governments developing and designing training programs.

Intervention in the labor market goes well beyond training at both the federal and provincial levels. The provinces have enacted legislation governing occupational health and safety, labor relations, workers' compensation, human rights, employment standards, pension benefits, and pay equity.[5] As well, they sponsor many apprenticeship programs and regulate an ever-increasing number of trades and professions, thereby governing entry requirements and the conduct of the individuals licensed to practice in these fields (see Appendixes A and B).

Since all these areas affect the functioning of labor markets across Canada, it is conceivable that the federal government could have used its declatory power (section 92(10)(c)) or tested the "peace, order and good government" clause (section 91) to establish national

4 The spending powers have been inferred by the courts from the federal government's taxing powers (section 91(3)) and its control over the public debt and property (section 91(1A)).

5 Pay equity is the newest area for provincial legislative involvement. Thus far, New Brunswick, Nova Scotia, Ontario, and Prince Edward Island have introduced legislation establishing rules governing compensation levels in jobs predominantly performed by women.

standards and objectives in them. Instead, it has only passed comparable legislation covering the federal labor jurisdiction.[6]

Ottawa does, however, intervene in labor markets in other ways. For example, the *Competition Act* enables it to challenge certain forms of anticompetitive conduct engaged in by professions regulated under provincial statutes. Challenges under the Charter of Rights and Freedoms have also impinged on provincial regulatory powers.[7] The proposed new federal bankruptcy law would raise the creditor status of workers. In addition, the federal government influences the performance of labor markets through the unemployment insurance (UI) system[8] with its specific regional benefits. Finally, there are the federally run pension schemes — the Canada Pension Plan and Old Age Security — as well as provincial legislation governing private pensions and Quebec's public pension program.

In brief, there are in place today a great variety and number of programs and laws that affect the functioning of labor markets. Many of them influence the relative bargaining power of employers and workers, circumscribe the decisionmaking latitude of employers, and interfere with worker mobility. The markets for the supply of many services — health care, business services, and social and

6 For example, *Canadian Centre for Occupational Health and Safety*, 1985; *Labour Code, Canada*, 1985; *Fair Wages and Hours of Labour*, 1985.

7 For example, in *Law Society of Alberta v. Black*, (1989) 58 D.L.R. (4th), 317, the Supreme Court ruled that the regulations restricting the ability of out-of-province lawyers to practice in Alberta infringed the mobility rights in section 6(2)(b) of the Charter. Justice LaForest stated, "The concept of Canada as a single country comprising what we now call a common market was basic to the confederation arrangements and the draft resolution of the British North America Act attempted to pull down the existing control barriers that restricted movement within the country" (at 334).

8 Section 91(2A) gives the federal government the legislative responsibility for UI. There is, of course, no reason why UI should be the sole responsibility of the federal government. The United States provides an alternative to a federally run system. The states are responsible for administering unemployment insurance, but the federal government sets guidelines and monitors state laws to ensure conformity with federal rules. Payments to the unemployed are of two basic types: regular state UI benefits, funded by employer payroll taxes set independently by each state; and extended payments, funded jointly by the federal government and each state.

public services — are also directly regulated, usually at the provincial level. But despite the extensive degree of intervention in labor markets, seldom is the distribution of jurisdictional responsibility clearcut, especially since concurrent responsibility has evolved in many areas, often in an unplanned or haphazard manner.

Proposals for Constitutional Reforms

There are two general schools of thought regarding the allocation of powers.[9] The public-interest school favors centralized intervention. Each level of government should be assigned the functions it can perform best; where there is doubt, the function should be assigned to the higher level of government. In contrast, the public-choice or antileviathan school favors decentralized decisionmaking in order to limit government intervention. Buchanan, one of the American scholars who popularized this view, argues that politicians are self-interested rent-seekers who exploit citizens and redistribute income and wealth to special-interest groups in order to maintain political power.[10] Free migration between local jurisdictions can compel local governments to compete with another and thus reduces the potential for the exploitation of individuals. At the national level, immigration restrictions prevent the migration of individuals from motivating this sort of competition. Capital is more mobile than people, and its movement can make national governments face some competitive pressures—but not enough to satisfy the desire of public-choice advocates to minimize government intervention.

The Federal Government's Proposals

The federal government's September 1991 proposals regarding the division of powers appear to be based on a combination of these two

9 See, for example, M. Neuman, "The Appropriate Level of Regulation in Europe: Local, National or Community-Wide? The Theoretical Rationale," *Economic Policy* 10 (1989): 467.

10 J. Buchanan, *The Limits of Liberty* (Chicago: University of Chicago Press, 1975).

views. *Shaping Canada's Future Together* emphasizes the importance of strengthening the economic union and the subsequent need to dismantle interprovincial barriers:

> A strong and well-functioning domestic market is essential to the well-being of all Canadians. Existing barriers to the mobility of people, goods, services and capital within Canada impede trade among the provinces and limit the mobility of individual Canadians. The inability of Canadians to benefit fully from the advantages of an internal market weakens their ability to compete effectively in the global economy.[11]

The federal government also stresses that simplicity and shared responsibility are among its criteria. To strengthen the economic union and dismantle economic barriers, it proposes that

> section 121 of the Constitution be modernized to enhance the mobility of persons, capital, services and goods within Canada by prohibiting any laws, programs or practices of the federal or provincial governments that constitute barriers or restrictions to such mobility.

In addition, the federal government suggests that

> the Constitution be amended to provide Parliament with a new power to make laws for the efficient functioning of the economic union,

which would provide a mechanism for the establishment of Canadian objectives, norms, and standards in a number of areas essential to the efficient operation of the economic union.[12]

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11 Canada, *Shaping Canada's Future Together*, at 29. This thrust is consistent with the direction the EC is taking. The reforms to the Treaty of Rome under the *Single European Act*, 1987, strengthen the Community's capacity to supersede the powers of the member states in areas such as training, gender equality, and recognition of professional qualifications and to act in the interest of the free movement of labor throughout the EC.

12 Ibid., at 30–31.

Adopting these proposals would open the door for extensive federal involvement in all areas of labor market policies and could result in Ottawa's preempting entirely responsibility for addressing labor market failures and related equity issues. For example, as Howse notes, "any government policy that distorts geographically the allocation of productive resources within Canada could be characterized as a barrier to trade."[13] But as the Macdonald Commission points out, although many interprovincial trade and factor mobility barriers may exist, their quantitative effect on the level of economic activity in Canada is not sufficient to justify a call for major reform.[14]

The federal government's specific proposal regarding labor market training appears rather odd in light of its economic union objectives. Although it recognizes that training is critical for Canada's competitiveness and for worker mobility and claims that training must be the product of a partnership among the federal and provincial governments, employers, and employees, it proposes a constitutional amendment to give the provinces exclusive jurisdiction for training. They would not, however, be left on their own to develop training programs. Rather, the federal government adds,

> [g]iven the importance of training to Canada's international competitiveness and future prosperity, leadership in the area of skills standards should be exercised jointly by the federal and provincial governments through the new head of power for managing the economic union.[15]

The schizophrenic nature of this proposal is compounded by the absence of any discussion of the respective responsibilities of the federal and provincial governments in other areas affecting the functioning of the labor markets.

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13 R. Howse, "Towards a High but Level Playing Field: Economic Union, Social Justice, and Constitutional Reform" (Paper prepared for the Centre of Public Law and Public Policy, Osgoode Law School, Toronto, 1992), at 10.

14 Canada, Royal Commission on the Economic Union and Development Prospects for Canada [Macdonald Commission], *Report*, vol. 3 (Ottawa: Supply and Services Canada, 1985), at 133–134.

15 Canada, *Shaping Canada's Future Together*, at 34.

A more appropriate means for dealing with jurisdictional overlaps, program rationalization and harmonization, and the removal of barriers might be the administrative delegation Ottawa proposes:

> [P]rogram standards would still be set by the federal government but program delivery could vary within the general guidelines from jurisdiction to jurisdiction.[16]

But for this approach to be effective, the federal government would have to retain its spending powers.

The Group of 22's Proposals

The Group of 22's proposals,[17] which predate those of the federal government, seem to be in a similar vein. It favors a strong central government to take control of the economy and emphasizes the need to establish the four economic freedoms — the free flow of people, goods, services, and capital — within Canada.

The group's approach is inconsistent in that it would give the federal government sole responsibility for economic matters and the provinces responsibility for social issues. Yet, as the Macdonald Commission concludes,[18] the two are inextricably linked. Social programs affect economic incentives. Income support may prolong the duration of unemployment or dissuade the unemployed from investing in retraining or relocating even if the investment would yield a net social benefit. Furthermore, as Howse argues, "Where the federal government has primary jurisdiction over most economic policies, but no social responsibilities, it will give short shrift to the social costs of economic policies, since these costs can be externalized to the provinces."[19]

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16 Ibid., at 38.

17 Group of 22, *Some Practical Suggestions for Canada* (Montreal: Group of 22, June 1991).

18 Macdonald Commission, *Report*, vol. 3, at 172–173.

19 Howse, "Towards a High but Level Playing Field," at 5.

Being cognizant of the interdependence between economic and social policies and desiring to minimize distortions and negative impacts on the four economic freedoms, the Group of 22 does recommend that national standards be established for social programs. But it tends to discount the difficulties that would arise in trying to reach an agreement on standards. Moreover, as Howse argues, provincial governments are not elected to define or represent the national interest; consequently, they are likely to promote only the interests of their constituents.[20] There is no assurance that the self-interests of the electorate in each province as perceived by the provincial leaders will coincide with the self-interests of these same people as seen by the federal government.

Constitutionalizing standards is not an attractive alternative either. If the standards are too general or imprecise, the courts will become involved in making social policy. If the standards are quite specific, their entrenchment in the Constitution might prevent future experiments or changes in policies.

In dealing specifically with training, the Group of 22 recommends that it "be a field of provincial jurisdiction, but that national standards be established to preserve mobility and where international competitiveness applies, it be concurrent."[21] This proposal is ambiguity at its best, for it is difficult to envision areas of training that could escape from the "international competitiveness" rule and so be exempt from concurrent jurisdiction.

Nevertheless, two of the Group of 22's observations on the proper division of powers for labor market policies merit serious attention:

> Confusion in government roles and in the minds of citizens is rampant....The nature of modern government will not permit us to allocate responsibilities with pristine clarity. Economic integration has been achieved so far in Europe by a reduction of national political powers, not the reverse.[22]

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20 Ibid., at 105. Howse also notes the failed initiative in the early 1970s to harmonize social policy through intergovernmental agreement (Ibid., at 133).

21 Group of 22, *Some Practical Suggestions*, at 23.

22 Ibid., at 9, 4.

Lessons from Other Jurisdictions

As Canadians seek the optimal distribution of powers for funding, setting, and enforcing labor market policies, they may be able to draw on the experience of other federations. The approaches used in the European Community and the United States are interesting both in what they have accomplished and in the objectives raised to them.

The European Community

The European Community uses both centralized and decentralized decisionmaking. On the one hand, the EC Commission can adopt regulations that are binding in their entirety on the member states and enforceable in the courts. On the other hand, the Commission can draw up directives that specify the results that must be achieved, and the member states have the authority to choose the means by which they will comply with the objectives; according to the Treaty of Rome (Article 189), such directives are binding on member states.

The same treaty (Article 57(1)) provides the European Council with the authority to issue directives for mutual recognition of diplomas, certificates, and other national qualifications in order to make it easier for individuals to pursue self-employed activities throughout the EC. In brief, each member state has the responsibility for setting for its own citizens licensing qualifications and rules and procedures for disciplining unacceptable conduct in various professions and trades. Individuals licensed to practice by one member state have the right to practice freely in the others, however. The home country maintains the authority to monitor the conduct of its citizens practicing in other jurisdictions. The mutual recognition of national standards and regulations is predicated on the establishment of *de minimus* EC-wide standards, implicit in the directives, which must be implemented in the regulations of each member state. The directives avoid prescribing detailed training requirements. Each country has the right to adopt more stringent standards and enforcement mechanisms.

There is an inherent conflict between adequate supervision and the freedom to practice throughout the Community, a problem the EC has recognized in a white paper. [23] But there remain significant differences of opinion over the appropriate levels of regulation. Therefore, problems of coordinating regulations have not been overcome and, as a result, directives have yet to be issued for several professions and trades.

The United States

An alternative to the EC directives approach can be found in the United States, which uses a bureaucratic approval procedure regarding state rules for the licensing or certification of professions. A federal agency can decide whether an individual state's rules are too restrictive; in such a case, the state must change its rules to make them acceptable to the agency. Any party can bring rules to the attention of the agency. Judge Breyer suggests that if the decisions are challenged, the courts would probably respect the decisions of the agency.[24]

Alice Rivlin, a former director of the U.S. Office of the Budget, writes that state governments should have clearer responsibility for most kinds of public investments than they do now. She recommends that federal funding of nonnational services, including training and social services, should end and that the states should receive transfers of resources adequate for funding these services.[25]

Rivlin offers the following reasons for her recommendation. As a result of internationalization, the federal government — in particular, the president — has less time to devote to purely domestic policy issues and the management of domestic programs. Furthermore, the federal government, with its enormous budget deficit and

23 Commission of the European Communities, *White Paper on Completing the Internal Market* (Luxembourg: Office for Official Publications of the European Communities, 1985).

24 S. Breyer, "A U.S. Perspective," *Economic Policy* 10 (1989): 479.

25 A. Rivlin, "Strengthening the Economy by Rethinking the Role of Federal and State Governments," *Journal of Economic Perspectives* 5 (1991): 3.

commitment to no new taxes, has no fiscal capacity for playing an increased role in training and the revitalization of public infrastructure.[26] Finally, most service-delivery programs need not be national in scope. They require flexibility and adaptation to local conditions; hence, they need a high level of public participation with the responsible public officials being visible, identifiable, and accountable.[27]

Rivlin dismisses the notion that devolution of many activities to the states would lead to a "race to the bottom" in terms of funding such programs and in setting various regulatory standards. Rather, she claims, economic competition among the states to attract business would become based on excellence of public services — high quality of education, infrastructure, and skilled work force — instead of tax and regulatory burdens.[28] This argument is important since it weakens the case for centralization that is based on fears that devolution to the provinces would reduce funding and standards.

Despite Rivlin's preference for decentralization and devolution of responsibilities, she does not rule out concurrent federal involvement. For example, she sees the federal government having an important role in solving problems that spill over state lines. Moreover, there would be certain activities for which states would not have the incentive to undertake programs that would benefit other states. As well, there would be programs in which national uniformity would be important for effective functioning of markets.[29]

Training

With all this background, we are ready to turn to specific areas of labor market policy, considering first whether any government intervention is economically justified and, if it is, how jurisdictional responsibility should be assigned in Canada.

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26 Consider, however, that in the Canadian context, shifting the responsibility to the provinces because of a lack of fiscal capacity on the part of the federal government would only shift the budgetary problems as well.

27 Rivlin, "Strengthening the Economy," at 10.

28 Ibid., at 13.

29 Ibid., at 9.

The first labor market policy to consider is training. Human capital is as important as physical capital in promoting economic growth and productivity. The Economic Council of Canada (ECC) has recognized the role and importance of human capital in most of its annual reviews. A commonplace postulate in labor economics textbooks and monographs is that training augments and upgrades the stock of human capital and thus increases labor productivity. Porter's recent study on competitiveness also highlights the critical importance of training in contributing to a nation's competitive advantage.[30]

Is Intervention Justified?

The importance of training does not in itself provide an economic basis for supporting a role for government in funding or developing it. Since the publication of Becker's classic work stressing the importance of property rights in training and distinguishing between general and firm-specific training,[31] economists and policymakers have attempted to justify a role for government participation. If a firm has an implicit property right to the returns to an investment in training — the case of investment in firm-specific training — it also has an incentive to make the investment.[32] On the other hand, if the individual has the implicit property right to the returns to a training investment — the case of investment in general training — the individual has an incentive to make the investment.

In the latter case, individuals will make the investment by paying for the training, either directly to some third party provider

30 Michael Porter, *Canada at the Crossroads: The Reality of a New Competitive Environment* (Ottawa: Business Council on National Issues and the Government of Canada, 1991). Porter suggests that the federal government play the lead role in formulating and financing training strategies.

31 G. Becker, *Human Capital* (Washington, D.C.: National Bureau of Economic Research, 1964).

32 As Salembier notes, specific, nontransferable training can impede labor mobility. Moreover, since the skills developed are of limited value in other jobs, firm-specific human capital faces an increased risk of obsolescence in the presence of economic shocks. G. Salembier, "Domestic Structural Adjustment Policies: A Comparative Survey" (Institute for Research on Public Policy no. 8503, Montreal, 1985).

or indirectly to the firm by accepting below-market compensation. In neither case is there an apparent market failure that warrants government intervention. Indeed, intervention in the form of minimum wage laws or unemployment insurance may diminish the ability of and incentives for individuals to invest in general training.

Several kinds of market failure are, however, possible for training and may justify government involvement. For example, general training on the job may be inefficient if there are economies of scale in the provision of training and if firms offer general training as a by product of their principal activity — the production, marketing, and distribution of goods and/or services.

Third-party provision of general training can capitalize on economies of scale and specialization, but it may encounter other problems. Individuals may be unable to borrow in the capital market to finance the direct and indirect (opportunity) costs of their training. Moreover, there may be significant externalities:

- the productivity of two individuals with different degrees of general training who work together may exceed the sum of the productivity of these individuals' working separately;
- general training also may enhance the productivity of other forms of capital;
- assuming that general training, human capital, and research and development (R&D) are complementary factors of production, a pool of generally trained workers may attract R&D-intensive firms and their interaction may significantly augment productivity (and competitiveness).

In either case — inability to borrow in the capital market or externalities — there exists a market failure that may lead to a socially suboptimal level of investment in general training.

In addition, as Wise notes,[33] a common objective for labor market policies is to enhance the employability of various groups in

33 L.R. Wise, *Labor Market Policies and Employment Patterns in the United States* (Boulder, Colorado: Westview Press, 1989), at 5.

the work force in order to improve the matching of the skills required by employers and the skills available in the labor pool. This rationale for government intervention may be supported by information failure in the labor market. Individuals may lack information on job opportunities and skill requirements and so be unable to evaluate the expected returns to various types of general training. The fixed costs of acquiring the information may be large, so large as to be onerous for any single person — though the marginal cost of disseminating the same information may be very low. Moreover, expected return may not warrant the required investment for individuals who lack the expertise to collect and/or evaluate information regarding future trends and demands. This information failure may support a role for government involvement in general training.

Government may also have an economically justifiable role in smoothing out the adjustment process and improving the functioning of the labor market in general. By facilitating a better matching of workers and vacancies, labor market policies — training initiatives among them — may reduce the natural rate of unemployment. Indeed, the ECC suggested in 1964 that labor market interventions may improve the unemployment-inflation tradeoff, enabling government to achieve lower levels of inflation and unemployment simultaneously. Noninflationary, high levels of employment require the efficient use of human resources, it said, and no country can achieve the maximum utilization of them without effective labor market policies.[34] Even though most economists no longer accept the concept of a permanent tradeoff, having a labor market that functions more efficiently — that produces more rapid, longer-lasting, and more satisfying worker-vacancy matchings — can reduce both the transitional unemployment costs of pursuing a low-inflation target[35] and the natural rate of unemployment.

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34 Economic Council of Canada *Economic Goals for Canada to 1970*, First Annual Review (Ottawa: Queen's Printer, 1964).

35 Recall that transition periods may be quite long. Canada is currently in its third year of adjusting to the Bank of Canada's low-inflation monetary policy.

Jackman, Pissarides, and Savouri[36] also emphasize the need for labor market policies to decrease the natural rate of unemployment, especially since the labor market may be prone to "hysteresis." That is, a decrease in demand may lead to a permanently higher level of unemployment as the labor market begins to operate less efficiently in matching unemployed workers and job vacancies. The longer individuals are unemployed, the poorer their chances for becoming re-employed. The longer unemployment spells persist, the more individuals' skills depreciate, the weaker their contact with labor market information networks becomes, the less confidence they have in themselves, the less willing they are to persist in job search, and the more likely that a prospective employer will believe that they are not potentially stable or reliable individuals. As a result, an economic downturn, even if shortlived, may be followed by adverse changes in the efficiency of the labor market in matching worker skills and job skill requirements.

Lower unemployment rates, alone or together with higher rates of productivity, may contribute to reducing the substantial costs associated with unemployment, costs stemming from poverty and the subsequent problems of poor health, crime, and marital breakdowns. Gunderson and Hamermesh even suggest that it may be globally efficient to reduce the pace of otherwise efficient market adjustment in order to minimize the potential adverse social consequences and additional costs, which are unlikely to be internalized in the labor markets.[37]

Expanding on this argument, they describe another type of market failure that may support government intervention.[38] They hypothesize that labor markets may be unable to internalize the costs and benefits of adjustments spurred by changes in productivity,

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36 R. Jackman, C. Pissarides, and S., Savouri, "Labour Market Policies and Unemployment in the OECD," *Economic Policy* 11 (1990): 450.

37 M. Gunderson, and D. Hamermesh, "The Effect of Free Trade on the North American Labour Market" (International Economics Program Working Paper DP 88–2, University of Toronto, 1988).

38 Ibid., at 3–4.

competitiveness, trade patterns, and trade agreements. In order for markets to internalize such externalities, market prices — in this case, wage rates — must reflect the likelihood of the occurrence of different types of events. In other words, wages should differ across jobs to compensate for their inherent adjustment risks — that is, their susceptibility to various economic shocks. But the information necessary for correct signals is not readily available. Even government may not be able to collect it. Government may, however, be able to provide *ex post* compensation (including retraining) and so minimize resistance to change.

The provision of labor market information and the funding or provision of training and retraining are examples of positive adjustment policies. Salembier[39] argues that such policies are preferable to defensive adjustment policies, including the provision of various types of subsidies, which enable uncompetitive firms and industries to survive, and protectionist trade strategies, which have similar objectives. Defensive policies, he says, tend to preserve existing economic structures and diminish the efficiency of the job-worker matching process in the labor market. Defensive policies reinforce rigidities in the labor market, thus elevating the natural rate of unemployment and increasing the resistance to change.

In its twenty-seventh annual review, the ECC states that no country can escape the labor market impacts of the continual change in the structure of global competition.[40] Only a properly functioning labor market that minimizes the economic and social hardships resulting from structural changes will permit these changes to proceed at appropriate rates and facilitate growth.

In summary, it appears that government does have some role in funding general training and in collecting and disseminating the information individuals need to make the correct training investment decisions. To maximize the adjustment potential and reduce the future costs of retraining, government should support the provi-

39 Salembier, "Domestic Structural Adjustment Policies," at 17.

40 Economic Council of Canada, *Transitions for the 90s*, Twenty-Seventh Annual Review (Ottawa: Supply and Services Canada, 1990), at 33.

sion of training that creates generic skills — transferable skills not tied to a specific occupation or trade — since occupational prospects change more rapidly than peoples' expectations and the capacity of educational and training institutions to adjust.[41] Training programs should focus on the development of generic skills that increase the opportunity for individuals to achieve higher degrees of flexibility and thus occupational mobility.[42]

Where Should Responsibility Fall?

Since there is an economic justification for government involvement in training, where should jurisdictional responsibility be assigned? Training is currently a provincial responsibility, but there is extensive federal government involvement. The latter has ranged historically from passive financial assistance — the first cost-sharing agreement was negotiated in 1944; this form of cooperation persisted through the application of the *Technical and Vocational Training Assistance Act* (1960) — to partnership based on federal-provincial training agreements (*National Training Act*, 1982), to more direct and active involvement (the Labour Force Development Strategy, 1989).

Federal government involvement in training can be supported by both an externalities argument — the potential productivity gains may extend beyond provincial borders — and a spillovers argument — employment opportunities may exist in other provinces. Even Rivlin, an advocate of decentralization and devolution, offers similar

41 The less diverse the skill mix of the work force, the more vulnerable it is to various types of economic shocks — technological change for workers specialized in high technology; changes in the terms of trade for commodities for workers specialized in resources. See Gunderson and Hammermesh, "The Effect of Free Trade," at 6.

42 Arthur Smith, an early proponent of generic skills, argues that the development of transferable skills facilitates occupational mobility and reduces the time and costs for subsequent retraining. See A. Smith, "Generic Skills: Improving Transferability in Occupational Training," Technical Study 34 (Ottawa: Federal Task Force on Labour Market Development, 1981). The ECC picked up the same theme a few years later. See Economic Council of Canada, *Strengthening Growth: Options and Constraints*, Twenty-Second Annual Review (Ottawa: Supply and Services Canada, 1985), at 41.

arguments for possible concurrent responsibilities (see the previous section).[43] Provinces have weak incentives to obtain information on job demands and trends outside their borders, and each devotes resources to training and augmenting its own stock of human capital, although the benefits may accrue to other provinces — in the form of either returns to the owners of capital or greater tax revenues resulting from increased levels of economic activity.

The ECC recognized these problems in its first annual review,[44] pointing out that no local community can be expected to assume the financial burden of providing training for displaced workers when they may have to move elsewhere to find jobs. Moreover, there is no point in a job seeker's moving to a new area if the person is uninformed about job opportunities or is technically unequipped to take advantage of them.

Therefore, there appears to be a good case for proposing that the federal government take a funding and information role but not necessarily a program-design role, except to ensure that training for jobs located in other provinces is funded. This position is reinforced by recognizing that only the federal government is in the position to pursue a goal of full employment and that human resource policies, especially training policies, are an integral component of an overall strategy to reduce the national rate of unemployment and keep the economy operating there. Furthermore, as noted independently by the ECC and by Arthur Okun,[45] adjustment and adaptation of displaced workers are more rapid and successful with a strong economy and low levels of unemployment.

Where does one go beyond this rather innocuous proposal for jurisdictional allocation? Howse advocates a strong federal role in the field of training. Although he does recommend federal primacy, he is highly critical of the federal government's proposal to give the provinces exclusive jurisdiction, claiming that doing so would be "in

43 Rivlin, "Strengthening the Economy," at 9.

44 Economic Council of Canada, *Economic Goals for Canada to 1970*, at 172.

45 A. Okun, "Upward Mobility in a High-Pressure Economy," *Brookings Papers on Economic Activity* (1973, no. 1): 235.

direct contradiction with the logic of a stronger economic union."[46] Trebilcock, Chandler, and Howse, on the other hand, argue that because of the linguistic barriers to individual mobility between predominantly francophone and predominantly anglophone parts of the country, it would not be appropriate for training to be exclusively or even primarily a matter of federal jurisdiction.[47] In light of these arguments, I am not prepared to propose exclusive jurisdiction for either Ottawa or the provinces.

To proceed further, I turn again to the ECC's first annual review, which offered an important insight into the allocation of jurisdictional responsibilities for labor market policies. It stated that the best employment policy at the national level has little prospect of succeeding unless there is effective cooperation at the provincial and local levels. Regional and local offices are in the best position for generating first-hand information about local labor market conditions, and without a highly organized communications system at the community level, the best developed training program is unlikely to succeed in attracting the right individuals.[48] The ECC has put forth similar arguments since then.[49] The Ontario Premier's Council also recommends partial decentralization, with decision making for training programs going to regional and sectoral training committees but overall responsibility for training and other labor market programs delegated to the Ontario Training and Adjustment Board.[50]

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46 Howse, "Towards a High but Level Playing Field," at 125.

47 M. Trebilcock, D. Chandler, and R. Howse, *Trade and Transitions* (Toronto: University of Toronto Press, 1987).

48 Economic Council of Canada, *Economic Goals for Canada to 1970*, at 183.

49 For example, its 1988 review notes that standardized, blanket approaches to the design and delivery of labor market programs have proved to be much less successful than decentralized approaches geared to local needs (Economic Council of Canada, *Back to Basics*, at 34). And its 1990 review observes that regionalization allows programs to be developed on the basis of reasonably up-to-date and complete information and offers solutions for the labor market problems of specific groups in particular regions. Economic Council of Canada, *Transitions for the 1990s*, at 44.

50 Ontario Premier's Council, *People and Skills in the New Global Economy* (Toronto: Premier's Council, 1990).

Thus, there may be a sound argument for proposing that program design be left to the provinces; that is, they should select the target groups, structure the training programs, and specify the method and magnitude of compensation for the direct and indirect costs of training. Federal-provincial conferences may be convened regularly to discuss these issues and review experiences in Canada and in other countries.

In addition, program delivery may be delegated to subprovincial boards or councils comprising representatives of labor, management, local government, and provincial government. The same groups could provide input into program design. Moreover, since the best structure for training programs may vary by industry, region, and/or the skill level and demographic characteristics of the labor force, local or regional boards may be best positioned to select the structure most appropriate for their areas.

In essence, I am proposing an explicit continuation of the present concurrent jurisdictional responsibility for training. The U.S. *Comprehensive Employment and Training Act of 1973* provides one model of how concurrency could operate. That Act shifted program development responsibilities to local levels of government using block grants from the federal government and federal audits of expenditures to ensure the use of funds within the guidelines set out in the legislation. In all, several hundred local government units were established to coordinate training initiatives under the act.

Alternatively, concurrency could be structured along the lines of the *National Training Act* (1982), a Canadian variant of the U.S. model. Federal-provincial agreements provide for the establishment in each province of a labor market needs committee responsible for identifying needs, recommending priorities, approving annual training plans, and recommending training initiatives. In addition, assistance provided under this act has encouraged experimentation in designing and in delivering training programs.[51]

51 Various incentives are used to encourage employers and public institutions to experiment with competency-based training, multiple entry/exit classroom instruction, computer-assisted individualized instruction, the use of employers' facilities for formal instruction, improved on-the-job training and job rotation, and preparation of training modules and self-paced learning programs.

If a more precise allocation of legislative responsibilities is desired, an acceptable alternative to concurrency would combine granting the federal government exclusive jurisdiction for training with administrative and legislative delegation as proposed by the federal government. Ottawa would have the sole responsibility for setting standards for training programs, but program delivery would be transferred to the provinces through administrative delegation. In order to address problems of language, the federal government could explore the possibility of going further for Quebec, delegating to it the authority to legislate in the area of training.

Apprenticeship

Today there are approximately 160 trades for which there is at least one provincial apprenticeship program in place (see Appendix A). The provincial rules specify the mix, content, and duration of on-the-job and classroom training that apprentices must complete in order to qualify as journeymen in particular trades.

The skills developed are not specific to a firm but are transferable to all firms in a particular industry and/or to a particular class of job required by firms in several industries that are related from a production point of view. Hence, it appears that the formalization and regulation of apprenticeship has had the objective of overcoming the problem of free riders and poaching that deterred employers from providing general training unless it is paid for by workers either directly or indirectly. The investment costs are still largely borne by apprentices, but the incentives for free riding or poaching have been diminished. Certification of apprentices may also have been formalized to assure the competence of apprentices.[52]

Is Government Intervention Justified?

Apprenticeship is essentially a formalization of the training process, and since there is an economic rationale for government involve-

52 In effect, the same objective set for occupational licensure, as described in the next section.

ment in training, it is tempting to put forward a similar rationale for apprenticeship programs. Yet, as suggested in the preceding section, training programs funded and designed by government should promote the development of generic skills. Apprenticeship programs focus on the development of job- or trade-specific skills, a significantly different approach. Indeed, the development of trade-specific skills may inhibit workers' ability to adjust to continually changing job skill requirements and necessitate more frequent or longer duration spells of retraining. As Arthur Smith points out, "Occupational specialization reduces mobility and increases the risks associated with a lack of skills diversity."[53]

The present structure of apprenticeship presents several other problems that cast doubt on the merits of continued government involvement in apprenticeship programs as distinct from involvement in training in general. Having the requirements for certificates of competence formalized in government regulation runs two key risks. The first is that the requirements tend to become fossilized — that is, outdated as technology and job skills change. Watson notes that the advent of new technology blurs the distinctions between trades and threatens the erosion of skills in the traditional trades.[54] Although nothing in law prevents the requirements from being regularly reviewed and updated, regulatory inertia is likely to introduce excessive lags into the adjustment process.

A second risk is associated with the capture theory of regulation: the regulations limit entry to a trade, and over time they tend to serve more the needs of the workers who possess certificates than the needs of the economy in general and of individuals desiring training in particular. This tendency also works to rigidify training and educational requirements, thus exacerbating the problems of structural adjustment.

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53 Smith, "Generic Skills," at 21.

54 See T. Watson, "Interprovincial Standards Program — A Model of Flexibility and Cooperation," Background Paper 29 (Ottawa: Federal Task Force on Skill Development Leave, 1983), at 6.

In sum, there does not appear to be a good economic argument to support formal apprenticeship programs as either a substitute for or a supplement to generic skills training.[55]

The case for government involvement in apprenticeship becomes even weaker when one realizes that provincial jurisdiction reduces labor mobility between provinces. MacNeil and Stein point out that it is impeded by a combination of each province's setting its own standards and regulations for licensing or certification, the lack of a common core curriculum, and the absence of provincial reciprocity.[56] Apprentices who move from one province to another may lose up to two years of credit. Since a certain number of hours must be spent on a job during each year of apprenticeship, the barrier to mobility can be particularly serious; apprentices who lose their jobs in one province may be reluctant or unable to move to another in which jobs in their trades are available. Therefore, it is not surprising to find a high dropout rate from apprenticeship programs during periods of high or rising unemployment.

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55 Some may question this statement by pointing to the apparent success of the German apprenticeship system. Although I cannot claim expertise on the German system, I make two observations. First, its success appears to be a reflection of the German federal government's commitment to full employment (though more in the past than at present). With skilled labor regularly in short supply, when skills became obsolete, companies could not afford to wait for other companies to retrain their workers and then hire them away. Thus, poaching was a less serious concern for all firms in Germany than in North America, and each had incentives to upgrade the skills of its workers periodically via retraining on the job. In effect, the German labor market operated along the lines described by Okun ("Upward Mobility in a High Pressure Economy"). Second, when workers in Germany did lose their jobs, they had a difficult time finding re-employment, in large part because the narrow focus of their training impeded their ability to move to other industrial sectors. During most of the 1980s, the average duration of unemployment in Germany exceeded that in Canada. Indeed, for most of this decade, hysteresis appeared to be a more serious problem for the German economy than for the Canadian economy despite the fabled apprenticeship system in the former.

56 E. MacNeil, and M. Stein, "A Report by the Sector Task Force on Mobility in the Construction Industry" (Ottawa, 1990), at 36, 38.

Where Should Responsibility Fall?

My preferred option is the complete disentanglement of government from apprenticeship programs and the reallocation of at least part of the resources to generic skills training programs. I recognize, however, that this course, may not be politically feasible or realistic in the short run.

My second-best (though decidedly inferior) option is based on recommendations made by MacNeil and Stein.[57] The federal government, using its present constitutional spending powers or a constitutional amendment granting it concurrent jurisdiction,[58] the federal government should ensure that uniform national standards are set, that they are adhered to by each of the provinces, and that reciprocity prevails. The arrangement could use the EC's directive approach, including the establishment of minimum standards and the concepts of mutual recognition and home-country regulation. Or it could be modeled on the U.S. system of federal oversight of state rules. (The latter option would necessitate the adoption of the federal govern-ment's legislative and/or administrative delegation proposals and the transfer of the necessary authority to the federal government by the provinces.)

Interprovincial cooperation without federal government participation and direction is unlikely to succeed in reducing existing mobility barriers. The Red Seal Program, the product of many years of interprovincial cooperation, has attempted to develop national standards and facilitate mutual recognition of licenses and certificates. But thus far it applies only to a small number of certified tradesmen. No headway has been made in providing for the inter-

57 Ibid. They suggest, at a minimum, setting a common core curriculum — including content and sequencing of subject matter — and having the federal government decrease its funding of all of a province's training programs if that province does not establish and achieve the uniform standards within a reasonable, predetermined time.

58 This could be accomplished through the federal government's proposals on the economic union.

provincial transfer of training credits for apprentices or in developing national standards for the certification of apprentices.

Occupational Licensure

Like apprenticeship, occupational licensure has mushroomed under exclusive provincial jurisdiction. Each province currently regulates a large number of professions and trades, concentrated in health care, business, and personal and social services (see Appendix B). The various statutes generally specify the education and training requirements to qualify for a license to practice in the specific profession and the types of conduct or practices that are acceptable (professionally ethical) or delegate the authority to establish these rules to an appropriately structured professional board.

Is Government Intervention Justified?

There is general agreement that the markets for many types of services exhibit an information failure, which is sometimes called the "lemons problem."[59] Consumers tend to have imperfect or incomplete information about the quality of a service and, in situations in which a supplier provides both advice and service, about the accuracy of the advice. Thus, in the absence of credible signals of or commitment to specific levels of quality and truthfulness, these markets can degenerate. Customers may correctly anticipate that only the lowest levels of quality will be available and only inaccurate advice be provided.

There is, however, no consensus among economists that government regulation is necessary to correct for the information failure. Matthews notes several options for dealing with the problem in the market for professional services.[60] Among them is "quasi" *laissez-*

59 See G. Akerlof, "The Market for Lemons," *Quarterly Journal of Economics* 84 (1970): 488.

60 R. Matthews, "The Economics of Professional Ethics: Should the Professions Be More Like Business?" *Economic Journal* 101 (1991): 737.

faire — that is, free, unregulated markets with consumers' having the right of civil actions for malpractice or, in extreme cases, criminal prosecution by the state. This option would probably be the preference of public-choice theorists, with their capture theory of regulation. Moreover, they would claim that the information failure is significant only for small and infrequent users of the services. Thus, regulation in the form of occupational licensure is likely to produce more economic losses than it reduces.

I believe, however, that there is sufficient market failure to justify government involvement in the regulation of various professions, although not necessarily all of those presently regulated.

In Canada, with the *Competition Act* covering services as well as goods and aggressive Directors of Investigation and Research who have been willing to challenge in the courts the anticompetitive practices of regulated professions, there is less scope for regulation to harm consumers than there is in some other countries. This conclusion is tempered, however, by the fact that the jurisprudence that has developed under the rubric of the "regulated industry defense"[61] has thus far limited the potential of the act to control anticompetitive practices sanctioned by provincial statutes.

It should be possible to structure regulations so that they correct the information failure and enhance aggregate consumer welfare. Of course, there is always the risk that the members of the agencies that interpret and enforce the regulations may be captured by the members of the professions regulated. But this possibility suggests not forgoing regulation but careful parliamentary monitoring of these agencies and/or amendments to the *Competition Act* directing the courts to constrain the application of the regulated industry defense. Implementation of the latter suggestion cannot be straightforward, however, because under the current Constitution, it would be tantamount to federal encroachment into an area of exclusive provincial jurisdiction. Thus, the proposed amendment to the *Competition Act* would have to be preceded by including in the Constitution the

61 See for example, *Attorney General (Canada) v. Law Society of British Columbia* and *Jabour v. Law Society of B.C.* (1980), 53 C.P.R. (2d) 87.

federal government's September 1991 proposal concerning the economic union.

Where Should Responsibility Fall?

For the responsibility for regulation, concurrent jurisdiction using the EC directive approach appears to be most attractive. The current exclusive provincial jurisdiction and the absence of national standards or reciprocity tend, as in the case of apprenticeship, to impede labor mobility. Charter challenges have recognized this problem, and if the *Black v. Alberta Law Society* case[62] becomes the precedent in such matters, some form of interprovincial cooperation in the setting of standards will be encouraged. If the four mobility rights become entrenched in the Constitution, as recommended by the federal government, then this case will take on added importance.

An alternative, offering a more rapid resolution to the problem and expanding the scope of the *Competition Act*, would involve granting the federal government the right to issue directives for the various regulated professions and trades. This goal could be achieved by directly incorporating this federal role in the Constitution or by adopting the federal government's proposals for broadening section 121 (the common market clause), adding section 91A (the power to manage the economic union), and creating a Council of the Federation.

The directives would set out general objectives, including mutual recognition, home-province regulation, and the prohibition of anticompetitive acts, as well as guidelines for minimum national standards to promote mutual recognition. The directives would be binding on the provinces in the sense that they would have to ensure that their statutes conformed. Individuals would have the right to challenge provincial regulations that did not conform.

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62 See Footnote 7.

Workers' Compensation and Occupational Health and Safety

Each province has enacted legislation for both workers' compensation and occupational health and safety. Workers' compensation essentially is a system of no-fault insurance in which employers generally are liable for the costs of injury or death at work,[63] regardless of who is at fault, and the liability tends to be exclusive since the injured worker or the estate of a deceased worker forgoes the right to sue for additional compensation. Laws governing workers' compensation have two primary objectives: to create incentives for employers to take precautions to reduce the risk of injury or death in the workplace, and to compensate workers who are injured or killed on the job.

Occupational health and safety laws establish standards for the workplace and set up agencies to monitor workplace conditions and practices to enforce compliance with the standards. The objective, in the words of section 2 of the 1988 Prince Edward Island statute, which is representative of the provincial laws, is "to secure employees...from risks to their safety, health and physical well-being arising out of, or in connection with, activities in their workplaces."

Three obvious questions arise. Is there any economic rationale for either type of legislation? If so, is there any need for both types — would either one alone not be sufficient? What level of government should have the responsibility for enacting and enforcing rules to increase the level of safety in the workplace?

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63 Of course, injury, disease, or death may not be entirely the consequence of a workplace accident or on-the-job exposure to toxic substances; other factors may contribute as well. In such cases, the provincial statutes tend to limit the liability of employers and hence the compensation to employees. For example, the Nova Scotia *Workers' Compensation Act* states: "Where the personal injury by accident results in injury or disease due in part to the employment and in part due to causes other than to the employment...compensation shall be payable for such proportion of the disability and disablement as may be reasonably attributed to the personal injury sustained" (section 9(2)).

Is Government Intervention Justified?

Oi states that, from the viewpoint of maximizing consumer welfare, the role of government policy in occupational safety should be to minimize the sum of accident costs and accident prevention costs.[64] Intervention to reduce the frequency and severity of industrial accidents or the duration and intensity of exposure to toxic substances is desirable only if there is a market failure that would lead to levels of safety that are socially suboptimal.

In a world of perfectly informed workers and complete and fair markets for disability and life insurance, there would be no market failure and no need for government intervention. Injuries and deaths would occur on the job, but there would be no economic justification for reducing the numbers. Wage differentials would fully compensate workers for job-related risks of injury or death, and these wage differentials would be reflected in price differentials that would discourage the consumption of products whose manufacture and distribution were inherently risky to employees. Oi even demonstrates theoretically that if workers were initially ignorant about workplace risks, over time they would learn the true risks, and wage rates would adjust to reflect them fully; the outcomes of the fully informed market would be replicated.[65] In this theoretical world, the introduction of workers' compensation with full and perfect experience rating of employers' premiums would not improve market outcomes. Wage differentials would disappear, but the total labor costs to employers would not change. Employees would no longer demand compensating wage differentials to acquire insurance; the workers' compensation system would provide insurance instead. For employers offering more risky jobs, wage rates would decrease, but this reduction would be offset completely by the experience-rated premiums.

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64 W. Oi, "On the Economics of Industrial Safety," *Law and Contemporary Problems* 38 (1971): 670.

65 Ibid., at 673.

Thus, only if there is an information failure in the marketplace and the wage structure does not fully incorporate accident costs to workers — that is, if it does not fully internalize the costs of different risks of injury and death — are there economic grounds for some form of government intervention to improve safety levels in the workplace.

Information failures are likely to arise in the case of new production technologies or jobs for which there is no previous record to determine the risks of injury and death. Even though information becomes available over time, there may be significant lags in its dissemination, especially if related job growth is rapid and newly entering workers are poorly informed and/or if there is a high rate of technological change. As well, statistical theory tells us that, in a case of small samples, one would need a relatively large number of observations to obtain a reliable estimate of the risks.

Concluding that there is a role for government in this area does not mean that the appropriate form of intervention is either workers' compensation or occupational health and safety rules. One alternative is tort liability, although workers' compensation appears to be preferable because it involves lower administrative costs. Yet after reviewing the administration, compliance, and enforcement rules of workers' compensation acts, I surmise that the aggregate administrative costs are substantial. Moreover, the incentives created by such statutes may fall short of correcting the market failure. Full (perfect) experience rating of premiums does not take place.[66] Compensation levels may be inadequate — the average value placed on human life may be too low. And as Dewees shows,[67] experience rating in general

66 For example, the Nova Scotia statute, which is typical, divides industries into nine aggregate classes for determining premium rates. Differences in accident experience among firms in the same class are not taken into account in setting the individual premiums. Thus, the precautions an employer takes to improve safety levels on the job have little, if any, impact on the premiums it pays. In effect, the return to the employer is close to zero. It is conceivable that the precautions are recognized by employees and so the employer benefits from lower wage costs, but in this case, workers' compensation plays no role in correcting for an information failure.

67 D. Dewees, "Economic Incentives for Controlling Industrial Disease: The Asbestos Case," *Journal of Legal Studies* 15 (1986): 289.

provides weak incentives if there is a long latency period between exposure to toxic substances and illness or death. Dewees also emphasizes a more general problem: Why would government officials be better informed about workplace risks than participants in the labor market?

Health and Safety Regulations, Workers' Compensation, or Both?

Are occupational health and safety regulations superior to workers' compensation in dealing with the information failure in labor markets? The answer is probably no. Oi argues that standards appear to be set without any consideration of economic costs and benefits and usually for readily identifiable hazards that are easily correctable.[68] Hence, they do not appear to improve the information available to both employers and their workers.

Viscusi, after studying the safety-enhancing effects of the U.S. Occupational Safety and Health Administration, concludes that the impacts have been negligible at best.[69] The combination of low penalties and a low probability per establishment of being inspected has not created a strong incentive for employers to comply with the regulations. The penalties set out in most Canadian statutes suggest that incentives in this country are equally weak.[70]

Occupational health and safety regulations may be useful as a backstop for workers' compensation when the latter by itself is inadequate to promote a socially optimal improvement in workplace safety. Yet both suffer from an information problem, so there is no assurance that the additional costs created by health and safety regulations can be justified by any incremental improvements they produce.

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68 Oi, "On the Economics of Industrial Safety," at 696.

69 K. Viscusi, "The Impact of Occupational Safety and Health Regulations," *Bell Journal of Economics* 10 (1979): 117.

70 For example, the maximum penalty on summary conviction in Nova Scotia is a fine of $2,000, imprisonment of a month, or both.

Regardless, since there is no consensus on the appropriate value for human life and suffering from injury or disease, it may be desirable from an economic perspective to err on the side of excessive precaution and favor the retention of both types of government intervention, although not necessarily in their present forms. Improvements are probably warranted, but a discussion along these lines is beyond the scope of this paper.

Where Should Responsibility Fall?

Turning to the final question — jurisdictional responsibility — one could argue that exclusive provincial jurisdiction could distort cost structures and relative provincial prices and so constitute an interprovincial barrier to trade, if not to labor mobility *per se*.[71] Consequently, one must decide how far to take the economic union argument in determining the division of powers. At one extreme, one could use it to support a very high degree of centralization of power. I do not believe, however, that this was the intent of the federal government, and even if it was, I do not believe that it would warrant centralized jurisdiction for workers' compensation and occupational health and safety regulations.

Exclusive provincial jurisdiction is my preferred option. Differences in provincial rules do affect investment and employment decisions, but there does not appear to be a good reason to argue against allowing provinces to make political tradeoffs between safety levels and investment — assuming that there indeed is an economic tradeoff between the two. One could argue that exclusive provincial jurisdiction would lead to a race to the bottom in terms of standards. But why would this outcome be more likely with provin-

71 The impediments to labor mobility do not appear to be substantial. Again using the Nova Scotia legislation as typical, the only provisions that could discourage workers from moving between provinces are those that reduce compensation for industrial disease in proportion to the exposure to a toxic substance while working outside the province. If a worker is able to collect compensation in only one province, such rules create a disincentive for workers exposed to toxic substances to move between provinces.

cial jurisdiction than with federal jurisdiction, given that differences in national rules affect international investment decisions?

Conclusions

The objectives of this paper were to explore the role of government in labor markets, particularly in training (including apprenticeship), occupational certification and licensing, and occupational health and safety, and to propose for each of these areas an appropriate allocation of legislative responsibility. To date, the various proposals that have been put forth for reforming the Constitution have dealt only with training. They have been silent on all the other labor market initiatives introduced by both Ottawa and the provincial governments during the postwar decades.

Recommendations

In deciding my preferences for the jurisdictional division of powers in each activity, I considered the following criteria: enhancement of efficiency — of labor markets specifically and of the economy in general; political accountability; and scope for flexibility and experimentation — that is, the ability of policymakers to modify program objectives, design, and delivery in response to critical economic events.

The efficiency criterion tends to favor federal primacy (sole jurisdiction) for correcting market failures in labor markets. But the other two objectives shift the balance toward federal-provincial concurrency in training, apprenticeship, and occupational licensing. In each of these cases, the federal government should take the lead role in establishing program objectives and guidelines, and the provinces should be delegated the authority for program design and delivery within the constraints of the national objectives. This situation could be achieved in various ways. For example, the federal government could be granted the explicit responsibilities in the Constitution and the provinces assigned their specific roles through

administrative or legislative delegation. Another possibility is adoption of the economic union proposal with the federal government claiming concurrent jurisdiction under that amendment. As well, the federal government could use its spending powers to establish national objectives in training and apprenticeship.

In the case of occupational health and safety — including workers' compensation — I favor exclusive provincial jurisdiction. Although it can be argued that differences in provincial rules can influence interprovincial investment and employment decisions and so be viewed as a barrier to trade across Canada, I do not believe that the federal government intended to use the economic union proposal to support an excessive degree of centralization. Indeed, paraphrasing the Macdonald Commission,[72] the quantitative effects on the Canadian economy of many interprovincial economic barriers may not warrant a change in the present constitutional division of powers.

Other Interventions in the Labor Market

Although I have not dealt with several other areas of labor market intervention, some brief comments on them seem in order.

For pay equity, employment equity, labor relations, minimum wages, and employment standards, I prefer exclusive provincial jurisdiction on the same grounds used herein to support that arrangement for occupational safety. (Of course, this conclusion presumes that there is a market failure justification for these types of provincial government intervention in labor markets.)

Unemployment insurance, on the other hand, must be treated differently. At present, the federal government has sole responsibility under section 91(2A). An alternative, already suggested, would be concurrent responsibilities modeled on the U.S. system. I strongly favor the current constitutional arrangement, however, for the following reason. The UI program has two legitimate goals: automatic

72 Macdonald Commission, *Report*, vol. 3, at 133–134. See footnote 14.

fiscal stabilization and income redistribution.[73] Only a national program can achieve these objectives. Unfortunately, there is no assurance that a federally administered UI program will pursue these goals. The reforms the federal government has introduced during the past several years have weakened the ability of the UI program to act as a fiscal stabilizer or to be a useful tool for income redistribution. Consequently, what is required at the present time is not a constitutional change in the allocation of responsibility for UI but rather a new round of reforms by the federal government to undo the effects of the most recent changes in the program and strengthen its ability to meet its goals.

Of course, one could suggest that, regardless of which level of government has responsibility for a UI program, funds should be transferred from it to training programs. Many people have pointed out that Canada spends about the same proportion of GDP on labor programs as does Sweden, but our spending is heavily skewed toward UI while Swedish spending emphasizes retraining and mobility-enhancing measures. In light of the Swedish example and of the importance many place on training, retraining, and mobility, perhaps Canada should retarget its spending on labor market programs.

I would support this position if the federal government were actively and continually committed to a full employment goal.[74] In this case, UI would be much less important. But in the absence of a credible commitment to this goal and the inability of the federal government, with its current budget deficit, to pursue expansionary fiscal policy, an UI program designed to achieve its two goals should be at the top of any list of government interventions in labor markets. Putting more money into training when the economy is operating with a high degree of slack would prove ineffective.

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73 Income redistribution must be a goal since unemployment is not distributed evenly across all members of the labor force. A disproportionate share of the unemployment burden tends to fall on low-income individuals.

74 Only the federal government has the necessary policy tools here.

Appendix A: *Trades Covered by Provincial Apprenticeship Regulations (as of 1990)*

In the parentheses, the first figure is the number of years of on-the-job training and classroom work required for certification as a journeyman in the particular trade and province. The second figure, if any, is the number of hours per year of work experience required for certification.

Appliance serviceman	N.B. (3); Alta. (3*1800); B.C. (3)
Assistant cook	Ont. (1*2000)
Automatic mechanist	Ont. (8000)
Auto glass installation	B.C. (3)
Auto radiator manufacturing and repair	B.C. (3)
Auto trimming	B.C. (4)
Baker	Ont. (4*2000); Alta. (3*1800)
Barber	N.B. (2.5); Ont. (3*1500); Sask. (2*1800); Alta. (2*1400); B.C. (2*1800)
Benchman	Alta. (4*1800); B.C. (1)
Boatbuilding	B.C. (4)
Boilermaker	Nfld., Sask., Alta. (3*1800); N.S., N.B., B.C. (3); P.E.I. (4*2000); Que. (3*2000); Ont. (4*1650); Man. (3*1600)
Boilermaker, marine	N.B. (4)
Boilermaker, shop	B.C. (4)
Bookbinding	B.C. (2)
Bricklayer	Nfld. (4*1800); N.S., B.C. (4); P.E.I. (3*2000); N.B. (3); Que. (3*2000); Ont. (4*1400); Man. (4*1200); Sask. (4*1500); Alta. (3*1600)
Cabinetmaker	P.E.I. (4*2000); N.B., B.C. (4); Man., Alta. (4*1600)
Cableman	B.C. (3)
Carpenter	Nfld., Man., Sask. (4*1800); N.S., N.B., B.C. (4); P.E.I. (4*2000), Que. (3*2000); Ont. (3844-7200); Alta. (4*1600)
Cement finisher	Que. (2*2000); Ont. (3*2000); Sask. (3*1200); Alta. (3*1200); B.C. (3)
Circular sawfiler	Alta. (3*1800); B.C. (1)
Cladding	B.C. (2)
Communication electrician	Alta. (4*1800)
Construction electrician	N.S., B.C. (4); P.E.I., Que. (4*2000); N.B. (5); Ont. (5*1800); Nfld., Man., Sask., Alta. (4*1800)
Construction millwright	N.B. (4); Ont. (4*2000)

Cook	N.S., N.B., B.C. (3); P.E.I., Ont., Man. (3*1600); Nfld., Sask., Alta. (3*1800)
Crane operator	Que. (1*2000); Sask. (4*1800); B.C. (3*1500); Nfld. (3*1800)
Diesel engine mechanic	B.C. (4)
Diesel fuel injection	B.C. (4)
Distribution system dispatcher	N.B. (3)
Drafting, architectural	N.B. (4)
Draftsman	N.B., B.C. (4)
Dry cleaner	Ont. (4*900)
Drywall finisher	B.C. (3)
Drywall installer	Man. (3*1600); Sask. (4*1500); B.C. (4)
Domestic and rural electrician	Ont. (4*1800)
Electric motor winder	N.B., B.C. (4); Man., Alta. (4*1800)
Electronics-CATV	B.C. (4)
Electronic technician (consumer products)	P.E.I., N.B., Ont. (4*2000); Sask., Alta. (4*1800); B.C. (4)
Electronic technician (trades)	B.C. (4)
Elevator constructor	Alta. (4)
Embalming	B.C. (2)
Engineering assistant	N.B. (3)
Farm equipment mechanic	P.E.I. (4*2000); Ont. (5*1800); Sask. (4*1800); Alta. (2*1800); B.C. (4)
Firefighter	N.B. (3)
Fitter (structural steel)	Ont. (3*1800)
Floorcovering installer	Que. (1*2000); Alta. (2*1600); B.C. (3)
Gas fitter	Alta. (3*1800); B.C. (2)
Glazier	Ont. (4*2000); Man., Sask., Alta. (4*1800); B.C. (4)
Hairstyling	Nfld. (2*2000); Ont. (3*1500); Sask., Alta. (2*1800); B.C. (2)
Hairstylist	Ont. (3*1580)
Heavy-duty equipment mechanic	N.S., N.B., B.C. (4); P.E.I. (4*2000); Que. (3*2000); Ont. (5*1800); Man., Nfld., Sask., Alta. (4*1800)
Heavy-duty equipment operator	Nfld. (4*1350); Que. (1*2000)
Hoisting engineer-boom truck	Alta. (1*500)
Hoisting engineer-mobile crane	Ont. (3*2000); Alta. (3*1300)
Hoisting engineer-tower crane	Ont. (2*2000); Alta. (2*1000)
Inboard-outboard mechanical repair	B.C. (4)

Industrial electrician	Nfld. (4*1800); N.S., N.B. (4); P.E.I. (4*2000); Ont. (5*1800); Man. (4*1600)
Industrial instrument mechanic	N.S., N.B. (4); P.E.I. (4*2000); Man. (4*1600); Sask. (4*1700); Nfld., Alta. (4*1800); B.C. (5)
Industrial mechanic-millwright	N.S., N.B., B.C. (4); P.E.I., Ont. (4*2000); Que. (3*2000); Man. (3*1600); Nfld., Sask., Alta. (4*1800)
Industrial warehouseman	B.C. (3)
Insulator	N.B., B.C. (4); Que. (3*2000); Sask., Alta. (4*1600)
Ironworker	Que. (2*2000); Ont. (3*2000); Alta. (3*1800); B.C. (3)
Jewelry manufacturer	B.C. (4)
Joinery	Nfld. (4*1800); N.B. (4)
Junior baker	Ont. (1*2000)
Landscape gardener	Ont. (4500); Man., Alta. (4*1500)
Lather	Que. (3*2000); Ont., Alta. (3*1800); Man. (4*1600)
Lineman	N.S., N.B. (4); P.E.I., Ont. (4*2000); Sask. (4*1700); Nfld., Alta. (4*1800); B.C. (3)
Lineman (construction)	Nfld. (3*1800); N.B. (3); Ont. (3*2000)
Locksmith	Alta. (4*1800)
Machinist	N.S., N.B., B.C. (4); P.E.I. (4*2000); Ont. (4*1500); Nfld., Man., Sask., Alta. (4*1800)
Machine fitter	N.S. (4)
Marine electrician	N.B. (4)
Marine engine fitter	N.B., B.C. (4); P.E.I. (4*2000)
Marine engineer	N.S. (4)
Meat cutter	B.C. (3)
Mechanic, aircraft	Man. (3*1800); B.C. (3)
Mechanic, electrical	N.B. (4)
Mechanic, elevator	Que. (5*2000); B.C. (4)
Mechanic, marine	Ont. (4*2000), B.C. (4)
Mechanic, small engine and powered equipment	Ont. (4*2000); B.C. (4)
Metal fabricator	N.S. (4)
Mine electrician	N.S. (3)
Mine mechanic	N.S. (3)
Mold maker	Ont. (4*2000); B.C. (4)
Motorcycle repair	Ont. (3*1800); Alta. (4*1600); B.C. (4)

Motor vehicle body repairer	N.S., N.B., B.C. (4); P.E.I. (4*2000); Nfld., Ont., Man., Sask. (4*1800); Alta. (3*2400)
Motor vehicle fuel and electronic systems mechanic	N.B., B.C. (3); Ont. (3*1800)
Motor vehicle machinist	Nfld., Ont. (4*1800); B.C. (4)
Motor vehicle mechanic	N.S., N.B., B.C. (4); P.E.I. (4*2000); Ont. (4*1800); Nfld., Man., Sask., Alta. (4*1800)
Motor vehicle partsman	Man., Alta. (3*1800); B.C. (3)
Motor vehicle steering, suspension, and brakes mechanic	N.B. (3); Ont. (3*1800); B.C. (2)
Motor vehicle transmission mechanic	P.E.I. (3*2000); N.B., B.C. (3); Ont. (3*1800)
Oil burner mechanic	Nfld. (3*1800); N.S. (3); P.E.I. (3*2000); N.B., B.C. (4)
Ornamental ironworker	Que. (2*2000)
Painter and decorator	N.S., N.B., B.C. (3); Que. (3*2000); Ont. (2*1800); Man. (4*1600); Nfld., Sask. (3*1800); Alta. (3*1600)
Painter-commercial/residential	Ont. (4*1800)
Painter-industrial	Ont. (2*1800)
Partsman	B.C. (3)
Patternmaking	B.C. (5)
Piledriver and bridgeman	B.C. (3)
Pipeline maintenance mechanic	B.C. (4)
Plasterer	Que. (3*2000); Ont. (4*1600); B.C. (4)
Plumber	N.S., N.B., B.C. (4); P.E.I., Que. (4*2000); Ont., Man., Sask. (5*1800); Nfld., Alta. (4*1800)
Power electrician	Man. (4*1600)
Power shovel operator	Nfld. (3*1800; Que. (1*2000)
Power system electrician	Alta. (4*1800)
Power system operator	Nfld. (3); N.B. (5)
Practical horticulture	B.C. (4)
Printer and graphics arts craftsman	Alta. (4*1800); B.C. (5)
Printer compositor	Ont. (4*2000); B.C. (5)
Printer-linotype operator	Ont. (4*2000); B.C. (5)
Printer-offset pressman	Ont. (4*2000); B.C. (4)
Production equipment mechanic	N.B. (4)
Projectionist	Alta. (1200)
Quartzware fabricator	N.B. (4)
Recreation vehicle mechanic	Alta. (2*1800)

Refrigeration and air-conditioning mechanic	N.S., N.B., B.C. (4); P.E.I., Que. (4*2000); Ont. (5*1800); Nfld., Man., Sask., Alta. (4*1800)
Reinforcing steel erector	Que. (1*2000)
Restoration stone mason	N.S. (4)
Roofer	N.B., B.C. (3); Que. (3*1500); Man. (3*1200); Sask. (3*1500); Alta. (3*1600)
Sawfitter	Alta. (4*1800); B.C. (2)
Secretary	P.E.I. (3*2000)
Security alarms installer	B.C. (2)
Service station attendant	N.B. (2)
Service station mechanic	N.S. (3); P.E.I. (2*2000)
Sheet metal worker	N.S., N.B., B.C. (4); P.E.I. (4*2000); Que. (3*2000); Ont. (5*1800); Nfld., Man., Sask., Alta. (4*1800)
Shipfitter	B.C. (4)
Ship's plater	N.B. (5)
Small equipment mechanic	Nfld. (3*1800); N.B. (3); B.C. (4)
Sprinkler system installer	Nfld., N.S., N.B., B.C. (4); P.E.I., Que. (4*2000); Ont. (5*1800); Man. (4*1700); Sask., Alta. (4*1800)
Staker-detailer	N.B. (2)
Stationary engineer	N.S. (6); Que. (5.5)
Stationary engineer (2nd class)	N.B. (4)
Steamfitter-pipefitter	N.S., N.B., B.C. (4); P.E.I., Que. (4*2000); Ont., Sask. (5*1800); Nfld., Man., Alta. (4*1800)
Steel fabrication	N.B., B.C. (4); Alta. (3*1800)
Survey technician	N.B. (3)
Survey technologist	N.B. (5)
Switchboard operator	N.B. (3)
Tile setter	Que. (3*2000); Sask. (4*1800); Alta. (3*2100)
Tool and die maker	Ont. (4*2000); Man. (4*1800); B.C. (5)
Transport refrigeration mechanic	Alta. (3*2100)
Truck and transport mechanic	N.S., N.B., B.C. (4); P.E.I. (4*2000); Sask. (4*1800)
Truck trailer repairer	N.B.; Ont. (3*1800)
Watch repairer	Ont. (3*1800)
Water well driller	N.B. (3); Alta. (2*1800); B.C. (2)
Welder	N.B., B.C. (3); N.S. (4); P.E.I. (3*2000); Man. (3*1600); Nfld., Sask., Alta. (3*1800)
Woodworker	Ont. (4*2000)

Appendix B: *Provincial Statutes Regulating Professions (1991)*

	Alberta	British Columbia	Manitoba	New Brunswick	Newfoundland
Accountants					
Chartered	S.A. 1987, c.C-5.1	R.S.B.C. 1979, c.2	R.S.M. 1987, c.C70		R.S.N. 1970, c.C34
General	S.A. 1987, c.C-3.6	R.S.B.C. 1979, c.1	S.M. 1989-90, c.64		S.N. 1984, c.27
Management	S.A. 1987, c.C-3.8	R.S.B.C. 1979, c.3	S.M. 1990, C.184		R.S.N. 1970, C.166
Agrologists	R.S.A. 1980, c.A-13	R.S.B.C. 1979, c.12	R.S.M. 1987, c.A40		S.N. 1988, c.30
Architects	R.S.A. 1980, c.A-44.1	R.S.B.C. 1979, c.19	R.S.M. 1987, c.A130		S.N. 1978, c.64
Barbers		R.S.B.C. 1979, c.25	R.S.M. 1987, c.B10		
Chemists					
Chiropodists			R.S.M. 1987, c.C90		
Chiropractors	S.A. 1984, c.C-9.1	R.S.B.C. 1979, c.50	R.S.M. 1987, c.C100		
Community planners					
Dentists	S.A. 1983, c.D-9.5	R.S.B.C. 1979, c.92	R.S.M. 1987, c.D30	R.S.N.B. 1973, c.H-3	S.N. 1983, c.26
Dental technicians	R.S.A. 1980, c.D-10	S.B.C. 1988, c.34	R.S.M. 1987, c.D31		
Denturists		S.B.C. 1988, c.34	R.S.M. 1987, c.D35	S.N.B. 1986, c.90	S.N. 1981, c.42
Dietitians	S.A. 1983, c.R-10.1		R.S.M. 1987, c.D75		R.S.N. 1970, c.257
Electricians			R.S.M. 1987, c.E50		
Embalmers			R.S.M. 1987, c.E70		S.N. 1975, c.39
Engineers	S.A. 1981, c.E-11.1	R.S.B.C. 1979, c.109	R.S.M. 1987, c.E120		S.N. 1988, c.48
Foresters	S.A. 1985, c.F-15.5	R.S.B.C. 1979, c.141			
Geologists	S.A. 1981, c.E-11.1				S.N. 1988, c.48
Hairdressers		R.S.B.C. 1979, c.159	R.S.M. 1987, c.H10		R.S.N. 1970, c.260
Hearing-aid acousticians					
Home economists			S.M. 1989-90, c.92	S.N.B. 1990, c.70	
Insurance agents, brokers					S.N. 1986, c.36

Lawyers	S.A. 1990, c.L-9.1	S.B.C. 1987, c.25	R.S.M. 1987, c.L100	S.N.B. 1983, c.13	S.N. 1977, c.77
Management consultants			S.M. 1986-87, c.49		
Medical doctors	R.S.A. 1980, c.M-12	R.S.B.C. 1979, c.254	R.S.M. 1987, c.H30	S.N.B. 1985, c.76	
Mortgage brokers	R.S.A. 1980, c.M-19	R.S.B.C. 1979, c.283	S.M. 1985-86, c.16	R.S.B.C. 1979, c.283	S.N. 1975-76, No. 49
Naturopaths		R.S.B.C. 1979, c.297	R.S.M. 1987, c.N80		
Nurses	S.A. 1983, c.N-14.5			R.S.N.B. 1973, c.H-3	
Registered		R.S.B.C. 1979, c.302	R.S.M. 1987, c.R40		R.S.N. 1970, c.268
Psychiatric		R.S.B.C. 1979, c.301	R.S.M. 1987, c.P170		
Assistants					S.N. 1983, c.50
Occupational therapists	S.A. 1987, c.O-2.5		R.S.M. 1987, c.O5		S.N. 1987, c.12
Ophthalmic dispensers	R.S.A. 1980, c.O-8		R.S.M. 1987, c.O60		S.N. 1981, c.46
Optometrists	S.A. 1983, c.0-10	R.S.B.C. 1979, c.307	R.S.M. 1987, c.070		S.N. 1981, c.40
Osteopaths					
Pharmacists	S.A. 1988, c.P-7.1	R.S.B.C. 1979, c.326	R.S.M. 1987, c.P60		R.S.N. 1970, c.295
Physiotherapists	S.A. 1984, c.P-7.5	R.S.B.C. 1979, c.327	R.S.M. 1987, c.P65		R.S.N. 1970, c.296
Pipe mechanics					
Podiatrists	R.S.A. 1980, c.P-11	R.S.B.C. 1979, c.330			
Psychologists	S.A. 1985, c.P-25.01	R.S.B.C. 1979, c.342	R.S.M. 1987, c.P190		S.N. 1985, c.19
Public accountants					R.S.N. 1970, c.313
Radiological technicians	R.S.A. 1980, c.R-3				
Real estate agents	R.S.A. 1980, c.R-5		R.S.M. 1987, c.R20		
Respiratory therapists			R.S.M. 1987, c.R115		
Social workers	R.S.A. 1980, c.S-17	R.S.B.C. 1979, c.389	S.M. 1990, c.96		
Teachers	R.S.A. 1980, c.T-3	R.S.B.C. 1979, c.19	R.S.M. 1987, c.T30		S.N. 1974, No. 50
Veterinarians	S.A. 1984, c.V-3.1	R.S.B.C. 1979, c.423	R.S.M. 1987, c.V30	S.N.B. 1990, c.70	R.S.N. 1971, c.73

Appendix B - *continued*

	Nova Scotia	Ontario	P.E.I.	Quebec	Saskatchewan
Accountants					
Chartered				R.S.Q. 1977, c.C-48	R.S.S. 1978, c.C-7
General					R.S.S. 1978, c.C-4.1
Management					R.S.S. 1978, c.1-3
Agrologists	R.S.N.S. 1989, c.8		R.S.P.E.I. 1988, c.A-10	R.S.Q. 1977, c.A-12	R.S.S. 1978, c.A-16
Architects	R.S.N.S. 1989, c.21	R.S.O. 1980, c.24	R.S.P.E.I. 1990, c.4	R.S.Q. 1977, c.A-21	R.S.S. 1978, c.A-25
Barbers	R.S.N.S. 1989, c.340				
Chemists				R.S.Q. 1977, c.C-15	
Chiropodists		R.S.O. 1980, c.72			R.S.S. 1978, c.C-9
Chiropractors	R.S.N.S. 1989, c.69		R.S.P.E.I. 1988, c.C-7	S.Q. 1973, c.56	R.S.S. 1978, c.C-10
Community planners					R.S.S. 1978, c.C-21
Dentists	R.S.N.S. 1989, c.125	R.S.O. 1980, c.196	R.S.P.E.I. 1988, c.D-6	R.S.Q. 1977, c.D-3	R.S.S. 1978 (Supp), c.D-5.1
Dental technicians	R.S.N.S. 1989, c.126	R.S.O. 1980, c.114		R.S.Q. 1977, c.D-3	R.S.S. 1978, c.D-6
Denturists	R.S.N.S. 1989, c.127	R.S.O. 1980, c.115		S.Q. 1973, c.50	R.S.S. 1978, c.D-7
Dietitians	R.S.N.S. 1989, C.361				R.S.S. 1978, c.P-28
Electricians				R.S.Q. 1977, c.M-3	
Embalmers	R.S.N.S. 1989, C.144				R.S.S. 1978, c.S-15
Engineers	R.S.N.S. 1989, C.148	R.S.O. 1980, c.394	R.S.P.E.I. 1988, c.E-8.1	R.S.Q. 1977, c.I-9	R.S.S. 1978, c.E-10
Foresters				R.S.Q. 1977, c.I-10	
Geologists					
Hairdressers	R.S.N.S. 1989, c.191				
Hearing-aid acousticians				R.S.Q. 1977, c.A-33	
Home economists					

Insurance agents, brokers		R.S.O. 1980, c.444			
Lawyers	R.S.N.S. 1989, c.30	R.S.O. 1980, c.233	R.S.P.E.I. 1988, c.L-6		R.S.S. 1978, c.L-10
Management consultants	R.S.N.S. 1989, c.65				
Medical doctors	R.S.N.S. 1989, c.281	R.S.O. 1980, c.196	R.S.P.E.I. 1988, c.M-5	R.S.Q. 1977, c.M-9	R.S.S. 1980-81, c.M-10.1
Mortgage brokers	R.S.N.S. 1989, c.291	R.S.O. 1980, c.295			R.S.S. 1978, c.M-21
Naturopaths					R.S.S. 1978, c.N-4
Nurses		R.S.O. 1980, c.196	R.S.P.E.I 1988, c.N-4	R.S.Q. 1977, c.I-8	
Registered	R.S.N.S. 1989, c.391				R.S.S. 1978, c.R-12
Psychiatric Assistants	R.S.N.S. 1989, c.319		R.S.P.E.I 1988, c.L-10		R.S.S. 1978, c.P-36
Occupational therapists	R.S.N.S. 1989, c.321		R.S.P.E.I. 1988, c.R-9		R.S.S. 1978, c.R-13
Ophthalmic dispensers	R.S.N.S. 1989, c.131	R.S.O. 1980, c.364	R.S.P.E.I. 1988, c.D-12	R.S.Q. 1977, c.O-6	R.S.S. 1978, c.O-5
Optometrists	R.S.N.S. 1989, c.328		R.S.P.E.I. 1988, c.O-6	R.S.Q. 1977, c.O-7	S.S. 1984-85, c.O-6.1
Osteopaths					R.S.S. 1978, c.O-7
Pharmacists	R.S.N.S. 1989, c.343		R.S.P.E.I. 1988, c.P-6	R.S.Q. 1977, c.P-10	R.S.S. 1978, c.P-9
Physiotherapists	R.S.N.S. 1989, c.344		R.S.P.E.I. 1988, c.P-7		S.S. 1983-84, c.P-11.1
Pipe mechanics				R.S.Q. 1977, c.M-4	
Podiatrists				R.S.Q. 1977, c.P-12	
Psychologists	R.S.N.S. 1989, c.368	R.S.O. 1980, c.404	R.S.P.E.I. 1990, c.49		R.S.S. 1978, c.R-14
Public accountants	R.S.N.S. 1989, c.369	R.S.O. 1980, c.405	R.S.P.E.I. 1988, c.P-29		
Radiological technicians	R.S.N.S. 1989, c.280	R.S.O. 1980, c.430			S.S. 1983-84, c.M10.2
Real estate agents	R.S.N.S. 1989, c.384			R.S.Q. 1977, c.C-73	S.S. 1986-87, c.R-2.1
Respiratory therapists					
Social workers	R.S.N.S. 1989, c.434		R.S.P.E.I. 1988, c.S-5		R.S.S. 1978, c.R-15
Teachers	R.S.N.S. 1989, c.462	R.S.O. 1980, c.495			R.S.S. 1978, c.T-7
Veterinarians	R.S.N.S. 1989, c.490	R.S.O. 1980, c.522	R.S.P.E.I. 1988, c.V-3	R.S.Q. 1977, c.M-8	R.S.S. 1978, c.V-6

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Fred Lazar analyzes the federal-provincial division of powers over key areas of labor market policy: training, apprenticeship, occupational licensing, workers compensation, and occupational safety and health. He suggests that government has a role to play when the market fails to provide the necessary programs, and he uses criteria such as accountability, responsibility, and flexibility to offer a provocative critique of Ottawa's proposals concerning jurisdiction over labor market policy and strengthening the economic union.

ISSN 1183-6253
ISBN 0-88806-300-8
$9.95